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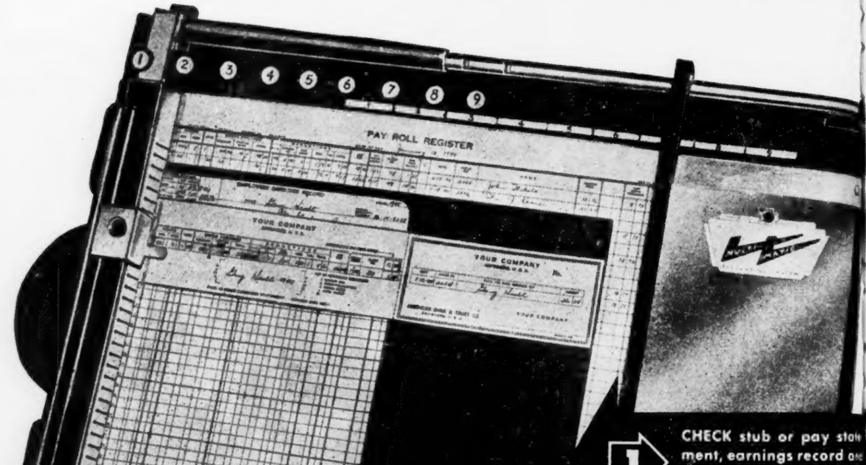

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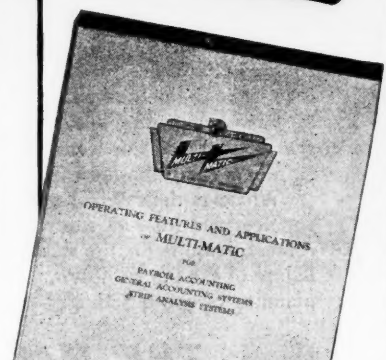

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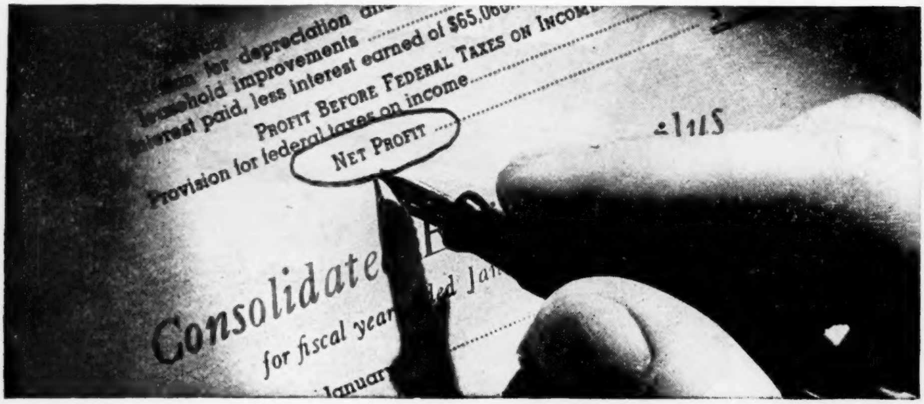

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VOL. XVI *January • 1946* NO. 1

The Administration of the Excise Tax Bureau of the City of New York

By GEORGE MARLIN

This is one of the three addresses presented at the meeting conducted by the Society's Committee on Municipal and Local Taxation held in the Engineering Auditorium, 29 West 39th Street, New York City, on November 29th, 1945.

WHILE the imposition of taxes by government authority may be a source of annoyance to taxpayers, I am willing to concede without much argument that the sales tax has engendered greater disfavor than most others. This is so for the obvious reason that this type of tax disregards the theory of "ability to pay" and is based upon individual transactions rather than upon net income, earnings or profits. Because every taxable sale requires the collection of at least one cent, it is often described by its detractors as a "nuisance" tax. As an abstraction, this point of view has some validity; unfortunately, however, the application of such nomenclature is at times linked with the manner of its enforcement which, of course, tends to reflect unfavorably upon the personnel of the Bureau of Excise Taxes. In the face of such criticism, I am able to find consolation in the thought that the payment of taxes is anathema to most persons in the same fashion as individuals requiring medical attention seek to avoid the doctor. Moreover, my conscience is assuaged since my approach to the tax problems confronting the Bureau of Excise Taxes has always been to attain an equitable result. I might state parenthetically that I have always been opposed in principle to the imposition of any tax which is not based on ability to pay. It is for this reason that I have given the question intensive study, but I am unable to subscribe to the alternatives which have been heretofore proposed, if indeed such alternatives were permitted by the State of New York.

GEORGE MARLIN served as Special Deputy Comptroller in charge of the Bureau of Excise Taxes of the City of New York from January, 1942 until December, 1945, and is now engaged in private practice as an attorney. He received the degrees of B.A. and LL.B. from St. John's University, Brooklyn, New York.

In analyzing the operation of the sales tax law, I have discovered that one of its most burdensome factors is the provision requiring the vendor to act as trustee of the tax which he has charged and collected from the ultimate consumer. While strict observance of this requirement entails clerical and bookkeeping expense on the part of the vendor, yet this is the only effective method available to the City if it is to realize its anticipated revenue. Difficult problems, however, are encountered in dealing with the vendor who has failed to charge and collect the tax

because he is made liable therefor nevertheless. Whether this omission arises from ignorance or misinterpretation of the law, or by a conscious act because of "the interest of the business", the reaction is always the same. Invariably the question will be posed, "How can you ask me to take money out of my own pocket when the tax itself was intended for the consumer?"

From what I have said thus far, it might be supposed that I favor either the abolition of the sales tax or the modification of the enforcement powers. Quite the contrary; my purpose is to create the impression that I make an effort to understand taxpayer psychology which serves as the springboard for our administrative technique. To the unimaginative mind, administration of a tax law requires unyielding and rigid construction of the statute without regard to the human equation. It is my policy in giving weight to the human equation to consider those elements or factors on which the law is silent, so that the result attained in any given case may be fair and equitable.

I haven't yet heard of a tax law that has been denominated perfect. But if its administration is to be deemed successful, complications caused by the over zealous who insist upon more power than the law specifically authorizes must be avoided. An honest attempt should be made to discover the statutory intent, which in and of itself does not require a strict or unusual construction of the verbiage employed.

I would like to outline to you the actual application of our administrative approach from the very beginning of the audit to the time the case is finally disposed of in the department. As you may know, taxpayers are selected for audit in our Audit Control Section via a system of elimination. The return for a particular period is desk audited and if found to be defective in a serious sense, it is set aside for full examination of the taxpayer's file. As a result, not more than 10% to 20% of the first desk audits are held for field audit.

By a seriously defective return, we generally mean that there may be one of numerous discrepancies or omissions appearing on the face of the return. The taxpayer usually files a gross receipts or business tax return as well as a sales tax return. Our first step is to compare the gross receipts reported on both returns. A substantial variance between the two would be a serious discrepancy. Emphasis is placed on the deductions taken, so that when the information contained in the return is at substantial variance with the general averages found by the department to prevail in various industries, this is also considered to warrant further examination. It becomes apparent on occasion that retail businesses claim deductions for resales which ordinarily would not be considered normal. Out of town sales may be used as the basis for unusual deductions, and so on.

Of course, examinations are also made on the basis of information submitted to the department from outside sources, or by direct request of the taxpayer, as is usually the case in assignments or reorganizations.

From this point on an auditor is assigned to audit the taxpayer's records. This is our first personal contact with the taxpayer and very often our first administrative problem arises here. We make it a practice to call the taxpayer by phone in order to arrange for a conference at his convenience. This procedure is routine. However, departures are necessary where taxpayers are unwilling to submit books for audit. Only last week a taxpayer who had agreed to a specific time for the commencement of an audit advised our field auditor that he would prefer to defer the examination until his accountant returned from an out of town business trip. The accountant had been called away suddenly so that the taxpayer had no means of knowing that his representative could not be present, at the time he agreed to the audit. The department auditor ex-

plained to the taxpayer that it was not necessary for his representative to be present while he conducted a routine examination of the records. Moreover, he pointed out that he was willing to hold in abeyance any conclusions pending the return of the taxpayer's accountant. Taxpayer was considerably upset over the prospect of an examination of his books in the absence of his accountant and appealed to me for a postponement. Upon receiving the assurance that the taxpayer's representative would be back within a reasonable time, I granted the request.

Possibly the most amusing request made for an adjournment involved a taxpayer who requested more time because his accountant was busy taking the C.P.A. exams. I wasn't sure that this was not a frivolous excuse but I granted the extension nevertheless.

Several years ago, I found it necessary to revise assessment procedure in order to expedite the disposition of cases. Today, our field auditors are authorized to obtain consents at the conclusion of the audit process if the taxpayer agrees to his findings. This practice has reduced the number of cases in our hearings section, to which the taxpayer may go for further consideration after an audit is concluded without an agreement having been reached.

The law guarantees every taxpayer a hearing, if it is requested within thirty days from the date of the notice of assessment. Here again, we follow a course of administrative substance, in that the first hearing, or as many hearings as may be necessary thereafter, is of an informal character. No provision is made for this practice in the law or the regulations, but we have found that an understanding is more quickly reached on an amicable basis in the absence of a formal record. We call this conference the "informal hearing", and it marks the first visit to the Bureau's offices by the taxpayer or his representative.

It is at this very point that some practitioners often utter a complaint to the effect that they do not know their rights. There really ought not be any room for confusion or uncertainty under the circumstances, because the very purpose of these conferences is to settle disputes in a conciliatory manner. Specifically, it is at these meetings that the taxpayer voices his objections to the basis of the determination and the resulting tax deficiency. Generally speaking, the most common objection flows from the fact that we employ a test check method rather than a complete detailed audit for an entire taxable period involved.

A detailed audit is generally made of a period which is considered to be representative in the taxpayer's business, on the theory that the results obtained from that test would be properly applicable to all the periods. Under such situations, as a matter of administrative policy, we permit the taxpayer or his representative to submit information indicating that a tax determined on the basis used in the Department's examination was neither proper nor representative. The Department might suggest that a test be made by the taxpayer or his representative, using a period which he considers to be more equitable and more representative. When we feel that the taxpayer's point is well taken and that the new test should be used, it is given proper consideration and the necessary adjustments are made. While upon the presentation of proper proof, we might agree that our test should not be applied, we might still not agree that the taxpayer's proposed test would be the correct one. During these informal hearings, however, a meeting of minds is reached, and the basis for a new test to determine the proper liability is agreed upon.

Another common objection encountered in the informal hearings concerns matters of law. In an effort to settle any differences which exist as to the law, the taxpayer or his representative

may request that the matter be taken before Tax Counsel for an informal opinion. At these hearings, the taxpayer is given an opportunity to present facts which might result in a reduction of the assessment. For instance, during the course of an audit, the taxpayer may not have available the necessary proof indicating that purchases made for his own consumption include the payment of the sales tax. Subsequently, let us say, he is able to obtain copies of bills, letters or affidavits from his vendors indicating that taxes were charged to him and paid by him. These informal hearings, therefore, serve as an extremely useful medium for the final determination and closing of a great many cases with facility and dispatch.

In the event an accord is not reached as a result of informal hearings, the taxpayer then has the legal right to a formal hearing, the purpose of which is to prepare a record upon which to base certiorari action in the event the taxpayer decides upon litigation. No request need be filed for a formal hearing if preceded by informal hearings, and the taxpayer is merely notified of the date set for the formal hearing. At the formal hearing, Corporation Counsel is represented by an Assistant, the Comptroller's Office is represented by the hearing conferee who is in charge, and the taxpayer must be represented by a lawyer even though an accountant represented him up to this point. Of course, the accountant may be present and participate in the hearing. The hearings are conducted under a rather liberal interpretation of the rules of evidence. During the course of these procedings Corporation Counsel may examine and cross-examine witnesses and the taxpayer, and the same right is accorded the taxpayer's representative. The power of subpoena is used by the Comptroller in an effort to facilitate these proceedings insofar as the production of witnesses or records may be concerned. After the formal hearings are completed, the entire case is reviewed. Thereafter, a final determination issues. If the taxpayer desires to litigate the matter in the Appellate Division, he is required to deposit the amount of the final determination and to post a bond for possible costs.

The next step therefore—and this step may be taken anywhere along the line after the notice of assessment is mailed—is to try to effect a compromise. The whole field of compromise and settlement involves a sort of twilight zone in tax administration. As far as the City Tax Laws and Regulations are concerned, there is no reference to the manner in which settlements are to be effected. It becomes entirely a discretionary matter for the person or persons authorized to dispose of matters in this fashion. In effect, this means that the burden falls on my shoulders as the Comptroller's Assistant in charge of the Bureau of Excise Taxes. I feel that this authority must be exercised with caution and care so that an offensive and bureaucratic type of administration may be avoided. At best, it is a delicate and sensitive proposition because its application may result in an arbitrary gain or loss of revenue to the City. A mathematical or legal error, resulting in an improper assessment, is not nearly as disturbing as a loss of revenue resulting from an error of judgment.

Now, let us consider the manner in which assessments are presented for compromise. At any time during the informal hearing stage, a taxpayer's representative may conclude that he has no further evidence to submit in support of his contention and he may feel that the hearing conferee is not giving sufficient consideration to his demands. Since the next step would be formal hearings and retention of counsel, the taxpayer might then make request for the settlement of his case by some other official. The Hearings Unit Chief or Tax Counsel will then review the matter and submit his findings to me. If his conclusions do not coincide with those of the taxpayer's

representative, the latter may then request a conference with me, at the conclusion of which a final decision is rendered. If the taxpayer does not agree with the findings, he still retains the right to go into formal hearings and ultimate litigation.

At this point, I'd like to give you an insight into the manner in which we in the Bureau of Excise Taxes approach settlements of any kind. As a matter of discretionary policy, we must first be sure that the taxpayer's position is reasonable. I suppose you might say that these are mere words while the power to determine what is and what isn't reasonable remains with me. But most normal human beings have a pretty good conception of the meaning of the word and a little exchange of opinion will result in some common area of agreement.

For instance, I don't think it is reasonable for any taxpayer to expect to settle a deficiency at less than the assessment figure just because he takes the time and trouble to go into hearings. Nor do I think it plausible for a taxpayer to assume that he is entitled to compromise a matter merely because he didn't understand the meaning or the workings of the law. There are a number of basically sound reasons for effecting a compromise, but if we keep in mind the two most prominent categories, then you'll have a pretty good understanding of what goes through my mind at the outset of compromise negotiations.

First of all, is there a genuine legal doubt in the position taken by the City? The rationale behind a legal doubt is that the City would stand to lose as much from litigation as would the taxpayer. As in any commercial venture, therefore, it's just plain, ordinary, common sense and good business practice to make a concession rather than risk losing everything. But as time goes on, we find fewer moot points as a result of a constantly growing set of legal precedents.

By way of illustration, I was asked to compromise a portion of an assessment because of conflicting interpretations of the statute of limitations. From 1933 to 1943, the City was not circumscribed in making audits by any statute of limitations. This special dispensation, which is very seldom found in any tax laws, was given the City because the revenues were applied for relief purposes. Since July 1, 1943, however, we have been restricted to audits for a three year statutory period. In the face of this limitation, we have been called upon to take a definite position in regard to what constitutes failures to file, or the filing of a fraudulent return. As regards a substantial omission — does it have a bearing on the failure to file, in effect, or does it constitute fraud? Some practitioners state categorically that the filing of a return, no matter how defective, sets up an insurmountable legal bar to any discussion as to what constitutes a failure to file. Others take the position that, unless clear motive or intent can be proven, beyond peradventure or doubt, we do not have the right to charge fraud under such circumstances. We don't quite accept either position, but we realize that there is some validity to such arguments. Here we are faced with genuine legal doubt and we have the basis for a compromise.

Refunds have always been a thorny problem because the law covering this field is of the harsh variety. Under the State and Federal statutes, payment under protest is sufficient to establish the taxpayer's rights in the matter of seeking a refund. The City law, however, requires that the protest must be in writing and that the grounds be stated in detail, and that a written application for the refund must be filed within one year from the date of payment.

Now, what constitutes a valid protest? Certainly, merely saying "I protest this payment" is insufficient. But it would be inequitable and unreasonable to require that a technical discourse at length be included in a

protest in order for it to be valid. We, therefore, read the protest language carefully and try to resolve the disagreement. In other words, there can be a very reasonable doubt about the legal interpretation under such circumstances, and we take full cognizance of it.

On the other hand, I don't think there's much legal doubt about the City's right to insist upon the full measure of tax at the effective rate from such establishments which fail to collect the tax upon each transaction. It seems incredible to some taxpayers and practitioners that the City should insist upon more than one per cent of gross receipts when the language of the law specifically sets the rate of tax at one per cent. This incredulity, in and of itself, does not create a legal doubt, because the law is so clear about the necessity for collecting a tax on every transaction, even though it results in revenue greater than the fixed rate.

Occasionally, we are called upon to compromise an undisputed assessment for the reason that the taxpayer's financial condition is poor. Financial stringency is more easily discernible than legal doubt because it lends itself to verification through written evidence and investigation. A bank balance, in and of itself, means very little, and must be considered in relationship to all other items appearing on the balance sheet, particularly current liabilities requiring immediate payment.

In any event, a financial statement is the first prerequisite to be introduced by one seeking compromise for reasons of inability to pay. I might suggest at this time that taxpayers and their representatives could save the City and themselves a good deal of time by calling to our attention the fact that, even though the assessment may be valid in all respects, it would be useless to carry it to its ultimate disposition in view of the weakness of the taxpayer's financial structure.

I would suggest you be as certain as possible that a reasonable case can be made out before you plead financial inability.

It might interest you to know that we are lenient in meritorious cases with taxpayers who have lost their legal rights through oversight, if the taxpayer can prove to the satisfaction of the Bureau that relevant and convincing evidence entitles him to a reduction of the assessment. Even after the issuance of a final determination and expiration of time in which to proceed with certiorari, we have permitted taxpayers to continue hearings on an informal basis. Of course, under such circumstances, we always reserve the right to proceed in strict accord with the law in the event the taxpayer's plea falls short of requirements. From my experience, I am convinced that many taxpayers would have less need to seek settlement or compromise if their cases were adequately prepared.

Finally, I should like to leave one word of advice with regard to those cases which develop complications because of ignorance or misinterpretation of the law. The common explanation that is so frequently offered is, "I didn't know about it" or "I thought this was the way your department wanted it done." The men in our Information Section at the Bureau of Excise Taxes spend all their working hours reviewing tax problems and keeping the public informed. If the problem confrontnig you is comparatively simple, a telephone call will bring you the desired information. A more involved problem should be dealt with by written communication or conference. In any event, a written statement of the Bureau's opinion will always place you in a better position should a disagreement arise in the future.

In closing, let me urge closer cooperation between the societies of lawyers and accountants and the Bureau of Excise Taxes. In this way, we can work together to achieve uniformity of interpretation and practice which should prove mutually beneficial.

Audit Problems of the Comptroller's Bureau of Excise Taxes

By JAMES T. ELLIS, C.P.A.

This is one of the three addresses presented at the meeting conducted by the Society's Committee on Municipal and Local Taxation held in the Engineering Auditorium, 29 West 39th Strct, New York City, on November 29th, 1945.

IN discussing the topic assigned to me, I shall confine my remarks to the purposes to be achieved by the Bureau audits, the general problems confronting the auditor and his approach to the solution of those problems, and the manner in which public accountants may cooperate with the Bureau. Because of limitations of time, my remarks will be directed principally to sales and use tax audits.

The Comptroller's Bureau of Excise Taxes administers all New York City sales, use, business, utility and conduit tax laws. Under all such laws, the Comptroller is the general administrative officer, and, among other duties imposed by law, he is required to conduct all audits, examinations and investigations to determine taxes due, and to make all assessments and final determinations, and hold all hearings upon disputed matters.

JAMES T. ELLIS, C.P.A., is a member of the Society, an associate member of the American Institute of Accountants, a member of the Municipal Finance Officers Association and of the American Society for Public Administration.

He has been guest lecturer on taxes at New York University School of Commerce. Accounting consultant to the City in the purchase of the subways in 1940, he was co-author of a paper on New York City's Transit Unification problem which appeared in the Public Utilities Fortnightly.

He is presently Audit Manager in the Comptroller's Bureau of Excise Taxes and in responsible charge of all taxpayer audits made under New York City's Excise Tax Laws.

The Bureau is comprised of a number of departments or units, the units being grouped into three functional sections: One section handles all matters pertaining to audit of taxpayer's records and verification of tax returns; one section deals generally with the hearings upon assessments and with legal questions, and one section handles all internal office routine services such as the file room, personnel records and like matters. The Special Deputy Comptroller is in responsible charge of the Bureau.

The audit section of the Bureau consists of a number of units, each specializing in a particular tax. A unit head is in responsible over-all charge of each unit, assisted by field supervisors who are group leaders in direct charge of 8 or 10 staff auditors. The entire audit section is in the general charge of the Audit Manager.

In the selection of auditing personnel, the Bureau policy has been to accept only men and women whose public accounting experience and training would qualify them for a C.P.A. certificate. A majority of the field men and virtually all of the supervisory staff are C.P.A.'s, many with considerable experience in public accounting; some are also attorneys. Most of the staff are equipped by training and experience to discuss

auditing problems with public accountants on a relatively equal basis.

During the past four years, the staff auditors have approached each audit assignment under instructions to verify the accuracy of tax returns through application of recognized audit tests, modified to fit the somewhat limited scope of a tax examination. In attaining this objective the auditor must be satisfied (a) that total taxable receipts have been reported by the taxpayer, (b) that the deductions made are proper, (c) that tax has been paid on all taxable purchases, and (d) that all taxes due have been paid to the City.

Audit tests are usually limited to examination of all transactions in a period which is typical of the entire period under review. In selecting the test period, the auditor is required to take into consideration such things as seasonal variations in business, changes in merchandising policy, increase or decrease in the number of outlets, and any other factors which might affect the validity of his findings.

Although the auditor has substantial latitude in the selection of periods to be audited and the extent and nature of the audit tests, he may not arbitrarily disallow deductions taken by the taxpayer nor recompute or modify total receipts as reported, without a firm basis for such action. Neither may he recommend an assessment based wholly upon estimates, except where the taxpayer is unable or unwilling to produce records of his transactions. However, if there are no records, an estimated assessment must be prepared and the auditor is authorized to use such external indices as are available and which he deems appropriate in the circumstances.

If the audit develops errors which are not significant, such as relatively minor clerical errors, the auditor may, with approval of the field supervisor, recommend acceptance of the tax returns as filed by the taxpayer. If this recommendation is accepted by the Special Deputy Comptroller after office review, appropriate notice is mailed to the taxpayer.

If, on the other hand, the audit develops errors of principle in charging, paying, collecting or accounting for tax, or significant errors in computing the tax, or if the taxpayer cannot produce competent proof of resales or proof of out-of-town deliveries, the auditor will compute an assessment by reducing the error factor, whether it be a mathematical error or the disallowance of resale certificates or other deductions because of lack of proof, to a percentage of the related base figure. For example, he may find that 20% of the amounts which the taxpayer had deducted as non-taxable resale items in the test period, are not supported by appropriate resale certificates. In such event, he will disallow 20% of all resale deductions in the entire period under review. The same procedure is followed by the auditor in computing the error factor in every class of item under examination, both receipts and deductions. Incidentally, the auditor will give the same weight to errors which favor the taxpayer as he does to errors which result in additional assessment.

Gross sales may be verified by examination of sales checks and other records and a comparison of such figures with the general ledger and the tax returns; gross profit is usually computed and compared with Bureau experience. The extent and nature of the verification will depend largely upon the type of business and the character of the accounting records and, in some cases, the results of the gross profit test.

In businesses where special tax collection and accounting procedures have been provided to accumulate sales and use tax, the auditor must be satisfied that the system is func-

tioning properly, and that internal controls provide reasonable safeguards against error. If the system is adequate, the subsequent audit will usually reveal only normal clerical errors. However, if the test reveals substantial discrepancies, independent tests of the sales transactions are made to compute the correct amount of tax. In such tests, and in audits where no special procedures have been established to accumulate sales and use tax figures, the auditor test checks a representative segment of the transactions in a typical period. In audit of a large retail store, the test may be limited to examination of the transactions for only a few days; in other businesses it may involve examination of all transactions for a period of months. In every audit, standard procedures require the examination of any loan and exchange and similar accounts on the taxpayer's books and the scrutinizing of any credits to purchases and expense accounts for evidence of hidden sales.

The schedules, analysis and working papers used by the taxpayer or his accountant in preparing the tax returns are always useful to the auditor. Such papers not only save time, but also serve as a check upon the work of the auditor and provide a basis for reconciling differences and for the computation of an assessment which is usually satisfactory to auditor must develop his own work- the taxpayer has no schedules, the both the taxpayer and the Bureau. If ing papers, which will be made available to the taxpayer at the close of the audit.

The experience of the Bureau over a period of years suggests that public accountants should design and install a system or fix a procedure which will enable his client, the taxpayer, to compute the sales or use tax due or collected upon all transactions subject to tax. I don't mean that the accountant should try to persuade every client to maintain elaborate sales check accounting systems such as are found in many large department stores. In some businesses, cash register tapes or similar devices will be found to be adequate as basic records of taxable transactions. In other businesses, a simple analysis of sales invoices is necessary. In some cases, copies of original sales checks are essential. For example, virtually every transaction in a retail hardware store, except sales for resale and for out-of-town delivery, would be subject to sales tax and the cash register tape might be adequate for audit purposes. On the other hand, a cash register tape is useless in audit of a restaurant selling both food and liquor. In such business the charge for liquor on a check totaling less than $1 is subject to sales tax whereas the charge for food is not taxable. Sales checks are therefore necessary to determine the non-taxable portion and to compute the correct tax. Failure to produce such checks for the audit might result in disallowance of all deductions which had been taken by the taxpayer for non-taxable food sales.

We frequently find that retail businesses report total sales in amounts substantially less than the cost of goods sold plus rent, salaries and other expenses and the owner's personal drawings. These people always protest that they are just "hanging on" waiting for better times. In a recent audit of one such taxpayer, operating a retail shop employing two or three clerks, the records showed a loss of about $15,000 every year. Nevertheless, after five or six years he purchased the business of his competitor next door, only to increase the annual loss. Although he had borrowed money to open the first shop, when pressed to explain how he managed to continue in business after losing more than $75,000, he could only shrug his shoulders and say "See my accountant, he should

know". We saw the accountant; he was not a magician.

In another case, involving a small restaurant in a good location, the taxpayer's accountant came to me complaining that the assessment was too high and that both the auditor and the hearing conferee were unreasonable. He had, he said, produced copies of earning statements and federal income tax returns to demonstrate that the City's estimate of gross profit on liquor was erroneous. All such statements showed a fair mark-up on food but no gross profit on liquor. He explained this by telling me that the proprietor always mixed the drinks himself, and was such a poor judge of quantity that he invaribaly mixed two or more drinks for each one ordered. It was the proprietor's practice, the accountant continued, to place the cocktail shaker on the table so that the customer could have both drinks although he was charged for only one; every drink was sold without profit. Needless to say, we could not accept that explanation and insisted upon a reasonable mark-up of liquor purchases in estimating the receipts from liquor sales. A satisfactory agreement was reached at a hearing.

In these instances, and in all cases where formal records of sales are not available, or are not complete, the auditor must resort to estimates, and he may compute a gross receipts figure based on bank deposits and on estimates of payments made direct from daily cash receipts for expenses and purchases and proprietor's withdrawals. In addition, statements are obtained from all known creditors, merchandise purchases are marked-up to retail selling price, and the result compared with the estimated receipts. Sometimes only the mark-up basis is adopted, but wherever other information is available which indicates receipts from sales, such information is used. Thereafter an estimated assessment is prepared and the burden placed upon the taxpayer to disprove the estimates.

After verifying or establishing the amount of gross sales, the auditor must test all deductions taken by the taxpayer as non-taxable sales. Verification of deductions, such as sales for re-sale, for out-of-town delivery or to charitable and other exempt organizations is usually on a test check basis. Here again, the working papers prepared by the taxpayer or his accountant in making the original tax return are of great value to the City auditor. However, the auditor will also require some form of proof that the amounts deducted are properly allowable.

Generally speaking, resale certificates obtained by the taxpayer in the usual and ordinary course of business will be accepted by the auditor as proof of the resale deduction. The auditor will, however, disallow any resale certificates which in his opinion are not proper. For example, he would accept as proper a resale certificate given by a department store to a dress manufacturer, but would reject a resale certificate given by the same department store to a printer on a purchase of stationery, sales slips or like items used in the business of the department store. While your off-hand reaction may be that any such rejection by the auditor is somewhat arbitrary, if you reflect for a moment, you will agree the City must insist that a vendor assume full responsibility for the validity of resale certificates accepted by him. We find that vendors are sufficiently familiar with the business of their customers to know, within reasonable limits, whether or not the item sold by them is for resale or for use by the customer. If the City did not apply this rule, it would be difficult, if not impossible, to collect sales taxes upon retail sales to business concerns except by audit of every such purchaser.

While the Bureau usually requires

a resale certificate as prima facie evidence of resale, under some circumstances collateral proof may be accepted. For example, if it is reasonably clear from the nature of the business under audit that the sales made were sales for resale by the taxpayer's customers, such as in the case of sales by a dress manufacturer, the failure to produce a resale certificate would not be fatal. Nevertheless, the City insists that every vendor obtain a resale certificate from his customers on all resale items, and might disallow resale deductions of the manufacturer if he consistently refused to obtain certificates.

Accountants can be of real help to the City by advising their clients to exercise reasonable care in acceptance of resale certificates. Also advise them to note the certificate number upon accounts receivable ledger accounts, or upon sales slips and other documents connected with the sale transaction, and to retain the certificates in their files for future examination by the City.

The validity of out-of-town deductions may be verified by examination of freight and express and other bills, and delivery receipts and other such proof. Deductions for delivery of jewelry, clothing, automobiles and like items to out-of-town points must be supported by specific and relatively detailed proof, but if the item is, for example, a piece of heavy machinery which cannot be moved without special equipment, collateral evidence such as contracts, customers orders, and shipping instructions may be accepted as proof of the out-of-town delivery. In other words, any documents which would satisfy a reasonable person that out-of-town delivery took place will usually be accepted by the auditor in support of this deduction.

Experience over a period of years has produced certain yardsticks which auditors may apply in testing the validity of this deduction. Experience indicates that a department store or other shop in midtown Manhattan will normally deliver a certain proportion of its sales to out-of-city points. If we find that a taxpayer in that area is making deductions at a ratio substantially different from Bureau experience, particular attention is paid to all records dealing with out-of-town delivery. Examination of insurance statements, parcel post receipts, and charges by delivery companies will quickly demonstrate the inaccuracies in the deduction, and the excess amount will be disallowed.

Verification of taxable purchases, i.e., purchases upon which the vendor failed to collect a sales or use tax, always involves a relatively detailed audit of purchase vouchers. If the principal purchases are items such as machinery and fixtures, the job may be simple. However, in audits of laundries, repair shops, contractors, and other persons who "consume" the goods purchased by them in their business, the task is more difficult and often reveals substantial unpaid tax. Test checks frequently show that certain vendors, usually located outside of New York City, regularly fail to charge tax and the purchaser neglects to accrue the liability on his books or to pay the tax direct to the City. Such items may go unnoticed for long periods and the City audit frequently results in a substantial assessment of use tax. Public accountants should pay special attention to these items and arrange to have the use or sales tax computed and the liability accrued and paid to the City as provided by law.

As one of the final steps in audit, the auditor is required to examine any tax accrual account, and to inquire into the basis of computation and the method of accrual. The auditor must also be satisfied that all tax returns have been filed and the tax

paid to the City. In this process he will automatically check the charges to the tax accrual account and question any which do not represent payments or proper adjustments of the accruals; credits will have been verified when testing sales transactions. Any balance remaining in the account at the close of the audit period will be included in the assessment unless the taxpayer can prove it arose as the result of error.

Public accountants should verify that all balances in tax accrual accounts were paid currently to the City as due and that accruals were in agreement with the returns as filed.

It is not necessary that the taxpayer's accountant be present while the City audit is in progress. After the auditor has completed his work and reviewed the proposed assessment with his supervisor, he will discuss the findings with the taxpayer or the taxpayer's accountant. The taxpayer and his accountant may examine the City auditor's workpapers; he may also make independent tests for comparison if he so desires. If the taxpayer's accountant is satisfied that the City auditor's tests were adequate, and that the assessment as computed by him is in accord with law, he should advise his client to sign a "consent assessment", which sets forth the amount of tax computed to be due and fixes terms for payment. If a consent is signed, the auditor will prepare his report recommending acceptance of the consent agreement.

The file submitted by the auditor for office review at the close of every audit contains work papers and supporting schedules and analysis, certain formal information with respect to the taxpayer's business, comments upon the extent and nature of the audit tests, the errors developed by such tests, the method of computing the assessment and any other relevant information. After approval by the audit supervisor, the report and all working papers are submitted for review by an audit review unit. The review accountants examine the file not only to check the adequacy and propriety of the audit tests, but also to determine that the error factors developed by the audit were properly applied and that the law and the Comptroller's regulations and rulings were followed in computing the assessment. If legal questions are present, tax counsel of the Bureau staff must also review the file. When the report is approved, the assessment is forwarded to the Special Deputy Comptroller, and, if accepted by, is signed and mailed to the taxpayer.

If the auditor and the taxpayer have failed to agree, and the taxpayer did not sign a consent, a formal assessment will issue, after appropriate office review, usually carrying full statutory penalties. Within thirty days thereafter the taxpayer may request a hearing. The first hearing is usually informal, and is in the nature of an over-the-table discussion with the taxpayer or the taxpayer's accountant. If agreement is not reached at such informal hearing or hearings, the taxpayer may request a "formal" hearing, at which he may appear on his own behalf, or by an attorney at law. The City will be represented at such formal hearing by an assistant corporation counsel, and the hearing will be conducted by one of the Bureau's conferees. Testimony is under oath and the record forms the basis for review of the assessment by the Appellate Division of the State Supreme Court. If the taxpayer concludes during the course of the formal hearing that the City's assessment is proper, he may sign a consent agreement, a final determination will issue and the hearing will be closed.

At the close of a formal hearing in cases where agreement is not reached during the hearing, the conferee may recommend either modi-

fication or affirmance of the assessment. If the conferee recommends modification and the modified amount is agreeable to the taxpayer when such information is conveyed to him, a consent must be signed. If no agreement can be reached in the hearings proceeding, the taxpayer may apply to the Appellate Division for review of the assessment and the dispute will be settled by the courts.

In discussing the work of the auditor, I have referred to the public accountant and the manner in which he can be of assistance to the Bureau. Generally speaking, the public accountant should have a reasonably complete understanding of the excise tax laws and the published regulations and rulings as applied to his clients. He should advise his clients on the design and maintenance of a system which will provide not only for the proper charging of sales and use tax, but which will result in an appropriate compilation of tax accruals under all laws. He should be satisfied that his client is securing adequate proof in support of exempt items. And he should keep his client informed as to the tax status of sales, receipts and deductions, and as to any changes in law or regulations which would affect such tax status. From time to time he should check to determine that the procedure for collection of sales and use tax and for compilation of all tax liability is functioning properly and with reasonable accuracy. He should, of course, verify the accuracy of the tax accrual account upon every audit.

The City has given serious consideration to the suggestion that returns prepared by C.P.A.'s should be accepted as correct without field examination. While practicing public accountants may be hesitant to accept this additional responsibility, which would be heavy, we find that both New York and out-of-city practitioners frequently submit certified statements in matters which arise in tax audits. As a general rule, such statements are carefully prepared and usually are accepted by the Bureau. The question of certifying tax returns does, however, merit further serious consideration by both the Bureau and by public accountants.

The Comptroller's Bureau of Excise Taxes is charged with responsibility for administering tax laws which affect every New York City business. The cooperation of public accountants can not only ease the task imposed by the various laws, but can bring to business men a better understanding of the law and a clearer appreciation of their responsibilities to the City. I feel that tonight's meeting is a step in the right direction; I sincerely hope it will pave the way for more active cooperation in the future between the Bureau and Members of the State Society, and of the accounting profession as a whole.

Interstate Commerce Problems Arising Under the New York City Sales, and Use and Gross Receipts Tax Laws

By MAX BROFMAN

This is one of the three addresses presented at the meeting conducted by the Society's Committee on Municipal and Local Taxation held in the Engineering Auditorium, 29 West 39th Street, New York City, on November 29th, 1945.

I HAVE been asked to discuss with you tonight some interstate commerce problems insofar as they are related to the New York City Excise Tax Laws. At the outset, may I remind you that my time being limited, I shall confine myself to a few highlights of the general problems that should be of interest to you, considering the fact, however, that millions of words have been written on the subject.

Sales and Use Tax

It is very important to understand the *nature* of the sales tax as distinguished from the gross receipts tax. The New York City sales tax is a transaction tax imposed on a purchaser. Transaction here means a sale of goods, which in turn, means the transfer of title or possession, or both, of tangible personal property within the city. The importance of an understanding of the nature of this tax will become apparent from what I have to say as I go on.

It is interesting to note briefly the chronological background of the interstate commerce problem as affecting the city's taxes, and the position taken by the City in recent years. In 1937, the City lost the *National Cash Register* case, 276 N. Y. 208, on the ground that imposition of the sales tax in that case violated the interstate commerce clause of the United States Constitution. For some unknown reason, the Supreme Court of the United States denied the City certiorari to review the State Court decision. In the meanwhile, other cases were pending in the office of the Comptroller involving substantially the same question. Finally, after processing through the State Courts and in January of 1940, the Supreme Court of the United States laid down the law as far as the constitutionality of the New York City Sales Tax Law was concerned as applied to interstate commerce transactions. In the case of *McGoldrick* v. *Berwind-White*, 309 U. S. 33, wherein the vendor, a Pennsylvania corporation maintaining a sales office in New York City, sold coal to a New York City purchaser which was delivered by the vendor from mines in Pennsylvania directly to the purchaser's place of business in the City of New York, the Court held that the imposition of the Sales Tax on the vendor was not violative of the interstate commerce clause; that the Sales Tax was a local, non-discriminatory tax on the purchaser and not on the seller, though the seller was required to charge, collect and pay the tax; that the transfer of possession to the purchaser within the city was the

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taxable event regardless of the time and place of passing title, even though immediately preceding transfer of possession the merchandise had been transported in interstate commerce and brought to its journey's end; that the tax does not aim at or discriminate against interstate commerce any more than other state taxes previously sustained by the Court.

So that, since the Berwind-White case, the law is pretty well settled, and the City has been encountering little difficulty in cases where merchandise is sold by New York City vendors and shipped from points outside the State of New York into the City of New York.

One of the immediate effects of the Berwind-White decision was the taxation of goods formerly not taxable under the Personal Property Tax Law of the City of New York. You may recall that under the Personal Property Tax Law, only certain specified categories of goods were subject to that tax and frequently, articles not coming within those categories, delivered by the vendors to the purchasers directly in the City of New York, were not subject to the Personal Property Tax Law, and no such tax was sought to be imposed by the City. However, since the Berwind-White decision placed emphasis on the taxable event occurring in the City of New York as adequate for sales tax purposes, the Comptroller held that wherever a retail purchase was made from an out-of-town vendor having no place of business in the City, where the goods were delivered by the vendor to the purchaser in the City, the purchaser became liable for a *sales* tax even though the goods could not be subjected to a personal property tax. This is very important, particularly for the periods prior to July 1, 1940, when the Personal Property Tax was superseded by the Use Tax, for obviously, if the City could not tax under the Personal Property Tax Law, the Berwind-White decision, in the City's estimation, was sufficient authority to tax purchasers under the Sales Tax Law.

Commencing with some time after the Berwind-White decision, a series of cases appeared in the office of the Comptroller which presented particular problems. These cases generally involved the liability of an out-of-state vendor having no office or established place of business in the City but who did business in the City of New York through a so-called manufacturer's representative or salesman, or who obtained orders by telephone or mail, and as a result of such orders delivered the goods directly to the purchaser in the City of New York. Before going into the difficulties involved in this problem, I would like to call your attention to two cases which were decided by the United States Supreme Court in 1944 which were analogous to the general problem facing the City.

The two cases referred to are *McLeod v. Dilworth*, 322 U. S. 327, and *General Trading v. State*, 322 U. S. 335. The McLeod case involved sales by Tennessee corporations having no office, representative or other place of business in Arkansas, as a result of solicitation of orders in the State of Arkansas by travelling salesmen, or by phone or mail, all orders being subject to acceptance in the home office in Tennessee. Arkansas sought to impose a sales tax on the Tennessee vendor. The identical facts existed in the General Trading case except that the vendor was a Minnesota corporation and the tax involved was a use tax imposed by the State of Iowa. The Supreme Court held the sales tax in the McLeod case void as being in contravention of the interstate commerce clause of the federal constitution. The Court distinguished the acts in that case from the facts in the Berwind-White case and found that the transfer of ownership, which was the taxable event under the Arkansas tax law, took place in Tennessee, and that Arkansas's powers of taxation could not be projected beyond its boundaries to tax an inter-

state transaction. In the General Trading case, the Supreme Court sustained the use tax of Iowa. It held that the use tax was a non-discriminatory excise tax laid on all personal property consumed in Iowa; that since the property was enjoyed by an Iowa resident who was the ultimate consumer, Iowa had the right to tax such use and that, making the out-of-state vendor a tax collector for the State was a familiar and sanctioned device. It might be interesting to note that in the General Trading case the taxing statute defined a "retailer maintaining a place of business" in Iowa and included any salesman or agent of the retailer, whether permanently or temporarily in the State, and that under the facts of that case, the Iowa court held the General Trading Company to be such a retailer—a finding which was binding on the Supreme Court.

On the face of it, these two decisions seem contradictory, and probably could only be justified on the tenuous distinction made between a sales tax and a use tax. More justification for the imposition of a use tax could be found in the fact that property which has been the subject of interstate commerce transportation could be subjected to a general property tax once that commerce ends. Therefore, it should follow that a use tax as applied to such property should be sustained. On the other hand, a sales tax, being a transaction tax, could be subjected to tax only if a local phase of the transaction occurs within the taxing state. Since, in the McLeod case, the transfer of ownership, which was the taxable event, took place in Tennessee, it could not be sustained by the Supreme Court.

After the decisions in these two cases, the Bureau of Excise Taxes reaffirmed its previous position in the case of out-of-town vendors soliciting business in the City through manufacturers' representatives or salesmen. In arriving at that conclusion, it has sought to distinguish between the McLeod case and the facts involving sales through a manufacturer's representative. It has been felt that in the latter case, there is more regular and continuous representation in the City to the extent that the conclusion is justified that the out-of-town vendor is in the City, if not in fact, then by representation. Accordingly, the Bureau holds that where out-of-town vendors make sales at retail through manufacturers' representatives or *resident* salesmen and deliver the goods directly to the purchaser in the City of New York, such vendors are liable for the sales tax and unquestionably for the use tax.

In the case of sales made by such vendors through the solicitation by traveling salesmen (distinguished from resident salesmen), or by orders obtained by telephone or mail, the Bureau holds, at least for the present, that such vendors are not liable for sales tax or use tax, though the purchaser may be. The basis for such position as to the sales tax is the McLeod case, even though the taxable event (the transfer of possession) occurs in the City of New York. The basis for non-liability of the vendor for the use tax in this situation is the fact that the New York City Use Tax Laws makes only those vendors liable for a use tax who maintain a place of business in the City, and the Bureau does not regard the presence of travelling salesmen or the taking of orders by mail or by telephone as the equivalent of maintaining a place of business in the City. Compare this with the statute in the General Trading case, where a retailer maintaining a place of business in the state, included anyone having an agent or salesman, even though temporarily in the state. But perhaps the more significant reason that the Bureau does not hold the out-of-state vendor liable where he solicits orders by travelling salesmen, or by telephone or by mail, is that from a jurisdictional or due process point of view, it is extremely doubtful whether such vendor could be subject to the tax. The Bureau desires to have such situations with such jurisdictional and due

process questions squarely raised and passed upon by the courts before it reconsiders its present position. There is little or substantially less doubt that such questions can affect the liability of those out-of-state vendors selling through a manufacturer's representative or resident salesman. But, as I previously observed, this problem does not affect the liability of the purchaser, either for sales or use tax, for the "taxable event" takes place in the City of New York.

Another phase of interstate commerce problems involves those transactions involving shipments across state lines, the taxation of which must conform to the provisions of the State Enabling Act. When I say State Enabling Act, I refer to the New York State statute which authorizes the City of New York to impose the Sales or Use Tax. In such Enabling Act are certain limitations which, insofar as the Sales or Use Tax is concerned, prohibit the imposition of a tax on any transaction originating and/or consummated outside of the territorial limits of the City of New York. Thus, where a New York City vendor makes delivery of his goods to a point outside of the City of New York, the sales tax does not apply, the reason being that the transaction was consummated outside the City of New York. (*C. G. Gunther's Sons* v. *McGoldrick*, 279 N. Y. 148; *United Artists* v. *Taylor*, 273 N. Y. 334) On the other hand, the fact that orders for goods are subject to acceptance outside the City and that the goods are shipped from points outside the City into the City, does not bring the transaction within the prohibitions of the Enabling Act. (*United Autographic Register Co.* v. *McGoldrick*, 260 A.D. 157, aff'd. 285 N. Y. 531).

Another type of transaction which involves the shipment of goods across state lines is that situation where a New York City purchaser buys goods for his own consumption in his business, receives them or brings them to the City of New York where they are stored in a warehouse or his regular place of business in the City, from which point he thereafter ships the merchandise to his out-of-city branches or places of business, where he uses them or consumes them. The City has imposed a tax, whether it be a sales or use tax, on such purchases, even though the goods were subsequently shipped to and used outside of the City. However, this was the rule of the Bureau up to April 1, 1945. Commencing with April 1, 1945, a ruling was issued by the Bureau, holding such purchases free from such tax on condition that the purchaser, nevertheless, pay the tax at the time of purchase and then take a credit in subsequent returns within one year from the date of payment, for so much of the tax as is applicable to the goods shipped and used outside the City, and provided, further, that adequate records are maintained to substantiate such shipments.

Gross Receipts Tax

Just as in the case of the sales tax, which is a transaction tax, it is important to understand the nature of the New York City Gross Receipts Tax. It is a privilege tax — imposed for the privilege of engaging in any vocation, trade, business, or commercial activity, or of making sales, and is measured by the receipts from sales made or services rendered. Under the early State Enabling Acts, there was no limitation on the Gross Receipts Tax as was true in the case of the Sales Tax. Express authority was granted to the City to impose a tax on gross income of persons, firms and corporations doing business in the City. Subsequent enabling acts of the State gave the City authority to impose a gross receipts tax in accordance with a model law set forth in the enabling act.

One of the outstanding features of the Gross Receipts Tax Law is the provision for the allocation of interstate commerce receipts. Before going into

the allocation provision of the law, I would like to acquaint you with some important cases that led to the adoption of the allocation provision.

Starting with 1938, the Supreme Court of the United States handed down a number of decisions which sanctioned the taxing of receipts from interstate commerce transactions to the the extent that they were attributable to the taxing locality. In 1938, the Supreme Court handed down a decision in *Western Live Stock* v. *Bureau of Revenue*, 303 U. S. 250, a case which involved a *privilege tax* on the business of selling advertising space measured by the sales price thereof. The Court held that the business of selling advertising space in a magazine is a local business which may be taxed if it is distinct from interstate commerce, and further held that the business of publishing magazine advertising was peculiarly local and distinct from its circulation in inter- or intra-state commerce. Because of the local character of the business and because the magazine had no place of business in any other state, the Court found that no other state could impose a tax on the receipts from sales of advertising space, and that there was no possibility of a multiple tax burden. This case first elucidated the apportionment doctrine as applied to gross receipt taxes and laid down the general rule that taxation of interstate commerce is valid when fairly apportioned to the commerce carried on within the taxing state.

In another case, *Adams Mfg. Co.* v. *Storen*, 304 U. S. 307, involving the Indiana gross receipts tax, the Supreme Court held that that was a direct tax on the receipts from commerce, without apportionment, not a privilege tax, in that it reached indiscriminately both to inter- and intra-state sales without apportionment, and that the entire tax must, therefore, fall. Thereafter, several other cases were decided by the Court, amplifying these principles, reference being made to them for those interested: *Gwin, White, & Prince* v. *Henneford*, 305 U. S. 434; *Dep't. of Treasury* v. *Wood Preserving Corp.*, 313 U. S. 62; *International Harvester Co.* v. *Dep't. of Treasury*, 322 U. S. 340.

Immediately after the decision in the Western Live Stock case, the City of New York, in its local law effective as of July 1, 1938, provided for allocation of interstate commerce receipts. This provision was sustained in 1942 in *Olive Coat Co.* v. *McGoldrick*, 287 N. Y. 769. Under the allocation formula, the tax reaches all interstate shipments, on an allocable basis, the percentage being subject to tax varying from a minimum of one-third to a maximum of two-thirds, depending on the factors used in the formula. It is used in every case of receipts from shipment of goods across the state lines. The significant feature of the allocation formula is that it taxes that part of interstate commerce receipts which is fairly attributable and allocable to the taxing locality, and thereby avoids any multiple tax burden.

Another type of situation involves those persons who are engaged in wholly local activities which effect goods shipped in interstate or foreign commerce. In 1937, the Supreme Court held invalid a gross receipts tax imposed upon receipts of a stevedore of vessels plying interstate and foreign commerce. (*Puget Sound Co.* v. *Tax Commission*, 302 U. S. 90.) This case, in the estimation of the City, has been overruled in effect by a line of cases commencing with the Western Live Stock case. The City's position is that where the activity or business is carried on *wholly* within the taxing state, there is no need for an allocation to determine what portion of the receipts from the transaction is attributable to the taxing locality. In such case, the entire receipts are taxable, for it is a matter of automatic apportionment to local business where no other jurisdiction could *possibly* tax. This was the situation in the Western Live Stock case and also in *American Mfg. Co.* v. *St. Louis*.

250 U. S. 459. In the latter case, the Court sustained a tax on the privilege of manufacturing goods for sale, which was measured by the receipts from all sales, inter-state as well as intra-state. The Court said that no allocation was required, since the activity or privilege taxed—the manufacture—was purely local and carried on wholly within the taxing statute.

There is now pending in the Supreme Court of the United States a case involving the New York City Gross Receipts Tax as applied to stevedoring operations (See *Carter & Weeks* v. *McGoldrick*, 294 N. Y. 906.) In view of the Western Live Stock case and numerous others, the City is confident of success in having the Supreme Court expressly overrule the Puget Sound decision.

Another major problem involving the application of the Gross Receipts is the taxability of out-of-state vendors doing business in the City through manufacturers' representatives. This involves the same factual situation as in the case of the sales tax heretofore discussed. The City puts such vendors in the same category as local merchants since they enjoy the same privilege of making sales in the City and engaging in business in the City. As to such vendors, it is the position of the City that they are liable for a gross receipts tax. (See Articles 106 and 211 of the Comptroller's Regulations.)

Another type of case which has caused quite a bit of discussion by practitioners is the so-called "third party rule", which went into effect commencing with Local Law No. 47 of 1941 (covering returns due on June 15, 1942.) A simple illustration of that rule is the situation where a New York City vendor sells goods to a New York City purchaser and causes them to be delivered by a third party located in another state, directly to the New York City purchaser. In such case, the City takes the position, under the third party rule, that the receipts from the sale by the New York City vendor are taxable in full. The theory behind the rule is that, as between the New York City vendor and the New York City purchaser, no interstate commerce is directly involved but that the shipment is deemed to originate in the City of New York; that the New York City vendor is engaged in purely local business and the tax on his receipts is for the privilege of engaging in business in New York City; that if interstate commerce is involved at all, it is only between the third party vendor in the other state and the New York City vendor. Under the third party rule, however, the receipts of the out-of-state vendor are not being subjected to the tax. The only exception to the third party rule is made when the New York City vendor usually ships the goods from his own factory or warehouse outside the state but occasionally has the goods shipped from a third party outside the state. In such case, the receipts from the sales by the New York City vendor are not subject to the tax prior to July 1, 1938, and are either allocable or non-taxable after that date, depending upon where the goods were delivered. For other examples of operation of the rule, see Article 211 of the Comptroller's Regulations.

Recently, the Comptroller has taken under consideration a change in the third party rule. The change will be to the effect that the shipment from a third party's out-of-city source of supply will be deemed to originate outside the City of New York and the receipts of the New York City vendor will be allocable if delivery is made to the purchaser in the City, and non-taxable if delivery is made to the purchaser outside the City of New York. Under the current third party rule, however, the first type of situation would be wholly taxable and the second one would be allocable.

Tax Minimization

By Chester M. Edelmann, C.P.A.

This is the text of an address delivered at a meeting of the Society's Committee on Federal Taxation at the Engineering Auditorium, 29 West 39th Street, on November 7th, 1945.

When Paul Seghers asked me to speak on the subject of Tax Minimization I was very happy because I thought that I'd spend two or three hours going over my notes and that would be enough for an acceptable hour's speech; however, I find that the time and effort involved would have probably been the same if I had written a book on the subject.

An hour's lecture will do very little justice to this subject. It would be about the same as if you asked a minister of the Gospel to give you a commentary and analysis of all the sixty-six books of the Holy Bible in an hour's sermon: it just can't be done. Naturally this address has to be somewhat selective, and I have decided to eliminate all matters pertaining to troublesome excess profits taxes, gifts and estate taxes, personal holding companies and special-type corporations. We will deal particularly with the average individual and corporate business taxpayer.

Now, tax minimization, as intimated by our Chairman Mr. Seghers, to me connotes a very sinister purpose. At least in the twenties and in the thirties it seemed to be that when you talked of tax minimization it was the development of a plan or procedure or scheme or hocus-pocus by which you had reasonable grounds to believe that you could get away with something, that it probably would stand up, and the worse that would happen was that later you would pay some additional amount and it would cost you the usual six percent interest. However, that is not my conception of the field that we are going to discuss tonight; I would prefer to call it "Tax Control" —in other words, it isn't what you can get away with, but how can you so arrange business transactions that you pay the smallest amount that the law legally requires you to pay, and if that amount happens to be zero then how you can totally avoid the payment of the tax. It isn't getting away with anything but rather from the point of view of not paying anything more than the law really requires you to.

No approach to this subject would be complete and of any value without a basic background; otherwise it would be like looking at the tree and forgetting about the forest. There are three important Supreme Court decisions that should be clearly in your minds before you at all discuss any plan or method of tax minimization. The first and most important is the Gregory decision (293 US 465-1935), which was handed down just a little less than eleven years ago. This decision cuts like the surgeon's scalpel at the roots of real tax evasion.

In this particular case, Mrs. Gregory was the owner of the United Bond and Mortgage Corporation, and that corporation, as one of its investments, owned stock of Monitor

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Securities Corporation. She wanted to get the stock of the Monitor Securities Corporation without the declaration of a dividend and without paying any tax. The following plan was evolved. She formed the Averill Corporation. Three days after that corporation was formed, United transferred the Monitor stock to Averill in exchange for Averill's common stock, which was a non-taxable exchange. Three days after that, Averill was liquidated and, at the request of United the Monitor stock was delivered to Mrs. Gregory as a liquidating dividend. That came within the letter of Section 112(g), involving reorganizations under the 1928 Act.

The Government contended that although they did comply with the letter of the law, this was just a lot of hocus-pocus. The only thing they intended to do was save the tax, but they didn't intend to continue the Averill Corporation in business. There was no business purpose in fact. The Supreme Court finally upheld that conclusion, reversing the Circuit Court which had agreed with the taxpayer on a purely legalistic basis.

I would like to read the decision of the Supreme Court in that case because it brings out several important points. It said:

"It is earnestly contended on behalf of the taxpayer that since every element required by the foregoing subdivision (B) is to be found in what was done, a statutory reorganization was effected, and that the motive of taxpayer to escape payment of a tax will not alter the results or make unlawful what the statute allows. It is quite true that if a reorganization in reality was effected within the meaning of subdivision (B), the ulterior purpose mentioned will be disregarded. The legal right of a taxpayer to decrease the amount of what otherwise would be his taxes or altogether avoid them by means which the law permits, cannot be doubted . . . But the question for determination is whether what was done, apart from the tax motive, was the thing which the statute intended. When subdivision (B) speaks of a transfer of assets by one corporation it means a transfer made in pursuance of a plan of reorganization, of corporation business, and not a transfer of assets by one corporation to another in pursuance of a plan having no relation to the business of either, as plainly is the case here. Putting aside, then, the question of motive in respect of taxation altogether, what do we find? Simply an operation having no business or corporate purpose—a mere device which put on the form of a corporate reorganization as a disguise for concealing its real character and the sole object and accomplishment of which was the consummation of a preconceived plan not to reorganize a business or any part of a business, but to transfer a parcel of corporate shares to the petitioner. No doubt a new and valid corporation was created. But that corporation was nothing more than a contrivance to the end last described. It was brought into existence for no other purpose; it performed, as it was intended from the beginning it should perform, no other function. When that limited function had been exercised it was immediately put to death.

"In these circumstances the facts speak for themselves and are susceptible of but one interpretation. The whole undertaking, though conducted in accordance with the terms of subdivision (B), was in fact an elaborate and devious form of conveyance, masquerading as a corporate reorganization and nothing else. The rule which excludes from considering the motive of tax avoidance is not pertinent to the situation because the transaction upon its face lies outside the plain intent of the statute. To hold otherwise would be

to exalt artifice above reality and to deprive the statutory provision in question of all serious purpose."

Five years later we came across another situation: Higgins, Collector v. Smith (308 US 473-1940). In this particular case, Smith was counsel for the General Motors Corporation. He organized his own personal holding company called the Innisfail Corporation, and, without a complete set of books but more or less by use of a current account, he recorded his many deals with the corporation. At the end of the year, he decided to establish a loss, and did so by selling securities to the corporation. The Commissioner disallowed the deduction.

The Supreme Court upheld the disallowance of those losses on the ground that they were not real. Whether Smith owned the securities personally or whether he had control of them in the corporation made no real difference and the loss under such circumstances was not recognized. This was the language that the Supreme Court used:

"If, on the other hand, the Gregory case is viewed as a precedent for the disregard of a transfer of assets without a business purpose but solely to reduce tax liability, it gives support to the natural conclusion that transactions which do not vary or control the flow of economic benefits are to be dismissed from consideration . . .

"A taxpayer is free to adopt such organization for his affairs as he may choose, and having elected to do some business as a corporation he must accept the tax disadvantages.

"On the other hand, the Government may not be required to acquiesce in the taxpayer's election of the form of doing business which is most advantageous to him. The government may look at actualities and upon determination that the form employed for doing business or carrying out the challenged tax event is unreal or a sham, may sustain or disregard the effect of the fiction as best serves the purpose of the tax statute. To hold otherwise would permit the schemes of taxpayers to supersede legislation in the determination of the time and manner of taxation."

Thirdly, we have a collateral decision and that is the Dobson case (320 US 489-1943). Of course a whole night could be given over to a discussion of that case, but its importance in this discussion is that the Tax Court was given conclusive authority to determine what is good accounting practice; whether a series of events should be considered as one or whether they should be considered separately. And the Supreme Court used this significant language:

"Whatever latitude exists in resolving questions such as those of proper accounting, treating a series of transactions as one for tax purposes, or treating apparently separate ones as single in their tax consequences, exists in the Tax Courts and not in the regular courts; when the Court cannot separate the elements of a decision so as to identify a clear-cut mistake of law, the decision of the Tax Court must stand."

The importance of this decision lies in the fact that the Tax Court is not merely bound by any one particular part of a transaction. As a matter of fact, in a case which will be discussed later, it considered as part of one transaction events which happened a year later. With these three decisions in mind we can now approach the subject of real tax minimization, and by that I mean how to legally prevent the overpayment of taxes. From these cases we may draw the following conclusions:

First, any tax savings plan must, as a minimum, at least comply with the letter of the law.

Second, the transaction must have a real business purpose, but if the commissioner finds it to his advan-

tage to disregard the business purpose he may do so. This was followed in the recent case of Survaunt 5 Tax Court #79. There the taxpayer claimed that the reorganization was a sham and that there was no business purpose. But to hold that way would mean that the taxpayer would have been allowed a loss, and the Commissioner didn't want that—he wanted a non-taxable reorganization. The Commissioner took the position that the Supreme Court gave him the election to recognize or not recognize the reorganization as best suits his purpose. He chose to recognize it, and the Tax Court upheld him. Although there is an appeal now pending, it is doubtful that the Supreme Court would go beyond the jurisdiction of the Tax Court in settling these matters of how transactions should be viewed.

Third, there must be a real or economic loss and not merely a loss in a legal or accounting sense. Some of the decisions which I will cite later will show that this principle has been applied where there have been legal losses but not economic losses.

Fourth, the Commissioner has the option to accept or reject the form of business organization adopted by the taxpayer, but the taxpayer is apparently bound by his own choice. In other words, taxpayer may not say that the corporation which he owns is a sham and that he should be taxed as if he had owned the property. The Supreme Court has said that only the Government may use that argument, but as far as the taxpayer is concerned, once he chooses a particular form, he is bound by it.

Fifth, for the purpose of determining questions of business purpose, the Tax Court has exclusive authority to treat a series of transactions as one in their effect, or to consider apparently separate ones as single in their tax consequences. It is possible that the Tax Court will also have final say as to the very existence of business purpose itself.

And, finally, the tax saving motive in itself does not vitiate nor nullify a plan if real business purpose can be shown as well as that the transaction resulted in an economic change in the taxpayer's position either as to property or control of the flow of income.

In addition to these limitations imposed by the Court's decisions, there are many provisions in the Internal Revenue Code itself which either restrict or deny the deduction of losses even though those losses may be genuine and bona fide. Some of these are Section 45, which gives the Commissioner the right to allocate income and expenses between controlled corporations; Section 129, which was added a few years ago and gives the Commissioner the right to disregard benefits derived through any acquisition for the purpose of either avoiding or evading taxes, particularly in excess profits; Section 118, which disallows losses on wash sales; Sections 24(b) and (c), which disallow bona fide sales and transactions between related taxpayers; and we also have Sections 166 and 167 which try to put some limitation on the taxation of trust income and, in these particular cases, make the income by statute taxable to the grantor even though the beneficiary actually gets the use of the money.

Despite all these restrictions and court decisions, there are still many many ways in which tax control can be brought into play. The law doesn't prescribe any particular method of accounting or any particular method by which the taxpayer should do business; but, once having adopted a certain method, or once having adopted a certain form, he is bound by the consequences.

Just to give one simple illustration, a firm wanted in effect to pay a stock dividend, but this is what they did. They drew checks to the

stockholders, then had the stockholders endorse those checks back to the corporation. The corporation issued additional stock and they thought, in effect, that it really was a stock dividend. Actually the corporation was no better off, because after the whole transaction was completed more stock was issued, the surplus was reduced and their cash position was unimpaired. As far as the stockholders were concerned they had more stock and their cash position wasn't changed. But it wasn't what they did but how they did it. They were actually taxed on the cash dividend although there was no intention of their getting the benefit of that cash.

The Internal Revenue Code itself is full of tax-saving devices, many of which are commonly used. The following is a partial list of the elections that the law gives to the taxpayer:

First, he has the right to use either the cash or the accrual basis.

He has the choice of accounting period: The option to close his books on a calendar-year basis or on a fiscal-year basis.

As to foreign income taxes, he may take them as a credit against the tax due or take them as a deduction, as best suits his purpose.

Compensation over a long period, under certain circumstances, may be treated in a beneficial way.

Certain recoveries of previously deducted expenses may be treated in a special way.

The taxpayer has an election as to the method of computing the value of his inventory. Some of the common methods are cost; cost-or-market whichever is lower; unit of production; and life; but, once having adopted a particular method, he ordinarily can't change it without the Commissioner's permission.

Other elections granted to taxpayers are separate returns; joint returns; consolidated returns; and installment method of reporting profit on sales. Then there is the optional tax form for small taxpayers and the standard deduction of $500 for large taxpayers. There is much that the taxpayer can do in the way of minimizing taxes by logically and intelligently using, under the different circumstances, all the options that are available to him.

Now, inasmuch as we are near the end of the year and this is the time that most business men and accountants take inventory of their situation, I will first discuss those matters which pertain particularly to year-end adjustments.

Cash Basis Taxpayers

There are two deductions which are limited by a certain figure called "adjusted gross income". That item is defined in Section 22(n) as the gross income less six deductions of which possibly only two or three are applicable to most taxpayers.

Contributions and medical expenses are dependent or are based upon that amount, so that in order to know whether or not the taxpayer is getting the full benefit of his charitable contributions or his medical expense he must be sure that his adjusted gross income is first determined.

Controlling contributions is a very simple matter for the cash-basis taxpayer. In the first place, the best thing for him to do is to arrange his contributions so that the large amounts are due near the end of the year. It is very difficult for the ordinary taxpayer who actually uses his full 15% allowance to know what his income is going to be before the end of the year; so one of the safest plans is to give a pledge at the beginning of the year and make payment in November or December. If the taxpayer finds that his income is going to be too small to permit the deduction of expected payments, he

may postpone the deduction by giving a note and paying it early the following year. Contributions are deductible only on an actual cash-payment basis. The fact that the note may be the equivalent of cash will not cause it to be considered a deduction in the year in which it is given.

On the other hand, as far as medical expenses are concerned, the situation is different. The amount deductible, subject to limitations, is the amount in excess of 5% of the adjusted gross income. Suppose the taxpayer has an adjusted gross income of, say, \$10,000. He would be allowed the amount spent in excess of \$500.00. Assume he spent only \$300 or \$400. If he has a \$100 or \$200 or some small amount to pay for the balance of 1945, there would be no tax advantage in paying it this year. When possible the payments should be deferred until January, 1946. All items can't be withheld at will, but there are times when a doctor or a dentist can be asked to wait a short period. On the one hand, you may have a situation where a person has large amounts of insurance premiums—disability, health and accident, the payment of which will be of no benefit in 1945. The annual premiums may be changed to a quarterly basis, only one-fourth of the premium being paid in 1945, and the balance being paid in 1946, when it may be of greater benefit to the taxpayer.

On the other hand, where the taxpayer's medical expense already exceeds 5% of adjusted gross income, it will be desirable to convert disability premiums to an annual basis before the end of the year and to pay in 1945 any unpaid portion of the insurance on an annual basis.

There are other items which are peculiar in their treatment and those are interest and taxes—Sections 23(b) and 23(c). For some reason which I am not able to understand, the Bureau treats these deductions differently from all others. Generally, most expenses—ordinary expenses—are deductible under Section 23(a), but interest and taxes are specific items of deduction. Therefore those items are deductible when paid, irrespective of how many years in advance you may pay them. On a cash basis if, in December, 1945, the taxpayer has paid January rent, that is not an allowable deduction for 1945 because it is an expense applicable to 1946. Again if the taxpayer paid insurance premiums for three years in advance, it is a capital investment, even on the cash basis, and it has to be prorated over the life of the policy. But, with respect to interest and taxes, it is different. In a recent ruling—IT-3740—the Bureau held that interest paid for five years in advance is deductible in the year of payment. Corporations in the excess profits brackets are in a position to profit this year by the advance payment of interest.

Taxes likewise may be paid in advance, with this exception: that the taxpayer can't deduct a tax that is not yet actually assessed. Consider the New York City real estate tax, as an example. It is levied on a fiscal year basis, July 1, 1945 to July 1, 1946. One-half is payable in October, 1945 and the other half in April, 1946. The taxpayer can pay the 1946 installment in 1945 and get the benefit of the entire tax this year. Of course, real estate taxes are usually not assessed for more than one year in advance, so that no deduction could be allowed for the 1947 taxes even if the City agreed to accept payment this year.

I find that one item which even large individual taxpayers are prone to overlook is the fourth quarter of their New York State income tax. That installment is due in January and ordinarily many of them pay it in January. If there is no difference in rates, there is no particular differ-

ence in tax effect; but next year there is going to be a difference, and if income is going to be the same there is nothing to prevent the taxpayer from paying his January, 1946 installment in December, 1945 and getting the benefit of that deduction in 1945.

The rule works both ways. If payment of taxes and interest will result in no benefit in 1945, they may be deferred until 1946 when the deduction may be of greater benefit.

With respect to interest I wish to comment on two particular situations. One is interest on margin accounts. The Bureau holds that such interest is not a deduction unless there are cash offsets, either dividends credited to the account or cash deposits made by the taxpayer. There are many cases where positions have been very inactive and the account is very well secured so that the interest accumulates during the year. Under such circumstances the interest would not be an allowable deduction; there must be a credit to the account; and, if there has been no activity at all in the way of dividends or cash, a check should be sent for the amount of interest in order to get the deduction.

Another item is interest on life insurance loans. It is very common to pyramid interest in the principal of a loan. In other words, if the taxpayer has a $5,000 loan, at the end of the year $200 interest is owed at 4%. He doesn't feel like paying it. The company sends him another note for $5,200. That is not a payment of interest. The taxpayer should pay the interest by check and then make his application for the $5,200 loan so that, in the end, he has his $200 back. He is in the same position, but in one case he gets the deduction and in the other case he he doesn't.

Taxpayers who do not use Supplement T or who do not claim the benefit of the $500 standard deduction should check their deductions to be sure that there are no doubtful or questionable items. The computation of one's tax on this basis is an irrevocable election not to take the benefits of Supplement T or the $500 standard deduction.

One of the most important items under tax control is capital gains and losses. With the exception of involuntary situations — condemnations, fires, redemption of securities —the taxpayer can't create a gain or a loss without some positive act on his part. There must be a sale or some other disposition. And, no matter how much depreciation there has been—or appreciation—there is no realization of a gain or loss until the taxpayer himself does something about it.

I find that many persons are making mistakes in differentiating between "short-term" and "long-term" holding periods. The regulations state that, for the determination of the holding period, the period starts with the day after purchase and ends with the day of the sale. When this is applied to security transactions differences of three of four days may exist between the contract dates and the settlement dates. As to securities sold on an exchange, it is the contract date that is controlling, not the settlement date.

Some taxpayers are confused by that because of the application of the settlement date in another situation. As to realization of gain on the cash basis, the gain is not taxed until the proceeds are available; if a sale were made on the Stock Exchange on December 30 or 31, 1945 and the settlement were made on January 2, 1946 that sale is not a 1945 sale but a 1946 sale.

However, on any basis, a loss is sustained when the contract is entered into; and even in those cases where the sale is to be made on the 30th or 31st of December, 1945, even though delivery of the stock will not

take place until January, 1946, the loss is sustained in 1945.

In close situations the taxpayer should check the holding period. The short-term gains are taxable at ordinary rates while the long-term gains are taxable at substantially lower alternative rates.

One system of accounting for gain is the installment method permitted under Section 44. That section is applicable in three situations; first, any dealer in personal property; second, any casual sale of personal property in excess of $1,000; and third, any sale of real estate. But the last two methods are subject to a provision that not more than 30% of the selling price must be received as initial payments. Initial payments are defined as those received during the taxable year.

This section may be used very effectively near the year-end. Assume a taxpayer has property held over six months which cost $7,000 and today it can be sold for $14,000. If he accepted $7,000 cash and took back a $7,000 mortgage, he would have to report the entire gain in the one year because he has received more than 30% of the $14,000 in the taxable year. But there is nothing to prevent him from receiving $4,000 now and $3,000 on January 2, 1946. In the taxable year 1945, he has received only $4,000, which is less than 30% of $14,000, and therefore the transaction qualifies as an installment sale.

However, in cases of installment sales, it is well to remember that a certain risk is involved. The taxability of future installments is governed by the law in effect when these installments are received and not by the law in effect when the transaction was consummated.

In the above example, the taxpayer will receive $3,000 in 1946, of which 50% will be taxable. But if this section is repealed in 1946 and all installments are held to be ordinary gain, the taxpayer then would have to pay tax on $3,000 of ordinary gain. On the other hand, it is conceivable though not likely that the capital gains provisions may be repealed or the alternative tax rate even further reduced. To that extent the taxpayer would get the benefit of any repeal or any reduction in rate.

An analogous situation exists with respect to the net operating loss deduction. In determining the amount of the net operating loss the taxpayer doesn't compute it on the basis of the law in effect in the year in which he sustained the loss, but he computes it in accordance with the law in effect in the year in which he wants to use that loss.

A common situation which you are likely to meet is the case of the taxpayer who has a prospective short-term gain. He doesn't want to sell because the gain is taxed as ordinary income, and yet he doesn't want to "miss the market". Can the taxpayer have his pie and eat it too? The answer is yes.

There are two situations. The first is where he wants to postpone the gain to 1946, and second and usually the more important one, is where he wants to convert the short-term profit into a long-term profit. To accomplish either result the taxpayer sells the stock short. In 1946 he closes this short position by either covering or by delivering his long stock.

Every closing out of a short position by repurchase is a short-term transaction. This is so because the holding period is at best only a few days from the date of purchase to the date of settlement. The date of the original short sale is of no signifiance.

However, when long stock is used to close a short position, the gain is either short-term or long-term depending upon length of time the long stock was held. The time interven-

ing between the short sale and the date of covering is of no importance.

It should be borne in mind that the procedure regarding short-term gains may also be applied to short-term losses. The principle is exactly the same.

No discussion of control of security profits and losses would be complete without mention of Section 118. This section disallows losses on wash sales as defined therein. It does not affect gains made under similar circumstances. It often happens that a taxpayer has capital losses which are of no immediate benefit to him. He may have appreciation in other securities. He can sell the securities at a gain and immediately repurchase them. The gain would be offset by previous losses and the net result is that the stock on which a gain was recognized has a higher basis for subsequent resale.

In making any definite plan for establishing capital gains or losses the taxpayer should take into consideration the capital net loss carryover provision and the net loss limitation of $1,000.

Cash basis taxpayers to a large extent may control ordinary income. This is particularly true of those engaged in rendering services. If fees, commissions, etc are received in 1945, they are of course subject to this year's rates, but if they are received in 1946, the income will be taxed at lower rates. Legitmate methods will obviously suggest themselves to the taxpayers to insure receipt of fees in 1946 instead of in 1945.

Accrual Basis Taxpayers

Taxpayers on the accrual basis do not have the same flexibility as those on the cash basis. Income must be included in the year in which the right to receive it arises, and expenses are generally deductible when the liability to pay becomes fixed, even though the amount is not definitely ascertainable. Strictly speaking, there is no such thing in the Code as a pure cash basis or accrual basis. There are many items which accrual basis taxpayers are required to account for on the cash basis and there are many items that the cash basis taxpayer may treat as if he were on the accrual basis. It is important from the point of view of "tax control" to know these differences and to apply them when possible.

Acrual basis taxpayers may benefit by the recent Supreme Court decision in Dixie Pine Products (320 US 516-1944). This case involved the question as to when a contested tax is deductible. The Court held that on the accrual basis a contested tax is not deductible until there is a final determination of liability upon the taxpayer and the year of final determination is the proper year for deduction—not the year when the tax was assessed. This reasoning would naturally apply to any item of expense.

However, in a recent Court of Claims decision — Chestnut Securities Co.—the taxpayer paid the assessment and then sued for refund. The government claimed that under the Dixie doctrine the tax isn't deductible until the year of final determination. The Court of Claims held that the year of payment was the proper year for the deduction. Taxpayers who are now involved in litigation should consider the advisability of payment in 1945, especially those subject to excess profits taxes. As an example, if a taxpayer is contesting a claim of $25,000, and is subject to excess profits taxes, he is much better off settling the claim this year for $10,000, than next year for $4,000.

The Dixie Case may also be used to advantage when the deduction in a given year is not desired. If there is a bona fide reason for contesting

the payment, the deduction could be postponed to a future year.

One of the items for which accrual basis taxpayers are required to use the cash basis is contributions. It is true that not too many corporations are concerned with the 5% limitation. If such a situation should arise the Corporation can give a pledge or a note and so transfer the deduction to a future year.

Another item that is deductible on the cash rather than the accrual basis is advertising under the following circumstances. If the taxpayer embarks on a campaign which he feels will benefit him over a period of years, he is not permitted to charge off the advertising over the estimated period but must take the entire deduction in the year in which the advertising expense was incurred.

Even as to income, there are many situations where the accrual basis taxpayer must report it on the cash basis. One of the most indefensible practices of the Bureau is to tax advance income in the year of receipt, even though the taxpayer is on the accrual basis. If a landlord in December, 1945 receives rent for 1946, the receipt is considered taxable income in 1945. The only exception to this rule allowed by the Bureau is in the case of magazine subscriptions. The income may be prorated over the term of the subscription provided that the expenses in connection with such income are likewise prorated.

As to dividend income the best authority is that it is taxable in the year in which received, although the record date or date of declaration may have taken place in a prior year. Thus a dividend declared December 15, 1945 to stockholders of record December 26, 1945, and payable January 5, 1946, is income in the year 1946. See Tar Products Corp. CCA-2 1942, and American Light & Traction Co. 3TC 1048; Koppers Co. Mem TC 2/29/44.

The accrual basis taxpayer may exercise a great deal of tax control even over ordinary income, and this is probably the most important phase of year-end adjustments. The most effective way to stop making money is to stop business and I think there is visible evidence of this slow down at present. It is difficult to see how taxpayers subject to the excess profits tax can be expected to keep their business going at a normal tempo when there is such a tremendous difference in tax rates. It is my opinion that the process of reconversion could have been stimulated if the reduction in tax rates were effective October 1, 1945 instead of January 1, 1946.

On the other hand it is to the advantage of the taxpayer to accelerate such items as reduce income, as sales returns, credits, allowances and claims, and quantity discounts. Where there are disputes with customers, it is advisable to settle them this year, and to write off bad debts.

As to closing inventories, utmost care should be taken in arriving at conservative valuations. Previously almost any merchandise could be sold; today the taxpayer is faced with a different condition. Particular attention should be given to war goods and substitute merchandise. It should be borne in mind that the taxpayer cannot change his method of inventorying without the consent of the Commissioner.

As previously pointed out, one election the taxpayer has is the choice of a fiscal or calendar year. This is particularly of interest to partnerships which were organized in 1945. In most cases it will be found to be desirable to have the partnership close its books on a fiscal year basis ending in 1946. The reason for this is that the partners include the partnership income in the year in which falls the close of

the partnership year. Thus in the case of a fiscal year or initial period ending January 31, 1946, the partners include their share of the income in their 1946 returns even though most or all of the income may have been earned in 1945. Test calculations should be made to determine which basis will be most favorable to the partners.

New Corporations also have the right to use a fiscal year basis. No general statement can be made as to whether the calendar year or fiscal year basis should be used. Taxpayers should consider the effect of the change in rates, and annualization of income for excess profits tax purposes before making any definite decision.

Undoubtedly, the drastic reduction in corporate rates will act as a deterrent for new partnerships and will cause many existing partnerships to revert to the corporate form. In connection with partnership dissolutions and formation of corporations, it is well to keep in mind the tax effect of GCM 20,251. This provides that when partnership assets are distributed in kind to the partners, the aggregate basis of the assets is the same, but there may be a redistribution of the values as to particular assets. The GCM says in effect that the basis of a particular asset in the hands of a successor corporation, is that percentage of the total basis as the fair market value of the particular asset is to the total fair market value of all the assets. The following set of figures will illustrate the effect of this GCM.

Asset	(1) Partnership Basis 10/31/45	(2) Fair Market Value 10/31/45	(3) % To Total Column (2)	(4) Column (3) Times $120,000
Receivables Net	$ 8,000	$ 8,000	5%	6,000
Inventory	40,000	32,000	20%	24,000
Fixed Assets Net	72,000	120,000	75%	90,000
Total Net Assets	$120,000	$160,000	100%	$120,000

The result is that the corporation's basis for inventory is only $24,000 as against the partnership basis of $40,000 so that its taxable gross profit will be $16,000 more than may be shown on the corporation's books. On the other hand the basis for the fixed assets has increased from $72,000 to $90,000.

The opposite effect may be achieved as illustrated in the following example, using the same partnership but showing different fair market values:

Receivables Net	$ 8,000	$ 8,000	8%	$ 9,600
Inventory	40,000	60,000	60%	72,000
Fixed Assets Net	72,000	32,000	32%	38,400
Total Net Assets	$120,000	$100,000	100%	$120,000

In this situation the inventory basis is stepped up from $40,000 to $72,000 so that the tax return should show $32,000 less gross profit than the books. The fixed asset basis will be reduced from $72,000 to $38,400.

Since it is likely that fair market values will in most cases be different from book values, the effect of this reallocation of the basis should be taken into consideration before any conversion is attempted.

Controlled Situations

It is readily understandable that the Bureau will scrutinize all transactions between related taxpayers. Some recent cases are worthy of mention. In Tri Lakes Steamship Co.—CCA-6 Jan., 1945, the taxpayer received all cash on the liquidation of its subsidiary under 112 (b) (6). That section provides that no gain or loss is recognized where property is transferred to a parent company in full cancellation of the subsidiary stock. The Bureau held that cash is not property and that gain is recognized to the extent of the cash received. The Court ruled that cash is property and that the liquidation was tax-free to the parent.

A fine example of tax control was shown in the recent case of Commissioner v. Day & Zimmerman CCA-3 9/2/45. This was another case of a 112 (b) (6) liquidation but here the taxpayer did not want a tax-free exchange. Taxpayer owned 90% of the stock of the subsidiary, and under this section a prospective loss of $400,000 would not be recognized, since taxpayer owned at least 80% of the stock. Accordingly, the taxpayer, prior to plan of dissolution, sold enough stock in a bona fide sale to its treasurer, to reduce its holdings to less than 80%. The Court held that Section 112 (b) (6) was not applicable since the taxpayer did not own at least 80% of the stock at the time of adoption of the plan of liquidation, and the loss was accordingly allowed.

An important decision under Section 24(c) was recently handed down in P. G. Lake CCA-5 4/17/45. This Section disallows deductions for interest and expenses accrued in favor of controlling stockholders if such expenses are not paid within two and one half months after the close of the year. The Tax Court in numerous cases has held that if the corporation was in strong enough financial position to make the payment, or even if it were able to borrow the money, there was constructive payment. The Fifth Circuit in this case stated that the language in the section is clear—the deduction must be paid within the prescribed period. It is not enough that the corporation could have paid it if it so desired. There must be actual payment.

Section 24(b) prohibits deduction of losses between related taxpayers. When related taxpayers engage in a series of transactions or sell a block of securities, each transaction and each item in the package must be treated separately. If it results in a loss, it will be disallowed; if a gain, it will be taxed. In the case of Morris Investment Corp. 5 TC No. 65, the Corporation sold to its controlling stockholder securities for $131,400 which cost it $131,600, sustaining a net loss of $200. The gains totaled $16,900 and the losses totaled $17,100. The losses of $17,100 were disallowed and the gains of $16,900 were taxed. To the same effect see Lakeside Irrigation 41 BTA 892 Aff'd CCA-5, 1942. In such a situation the securities resulting in losses should be sold on the stock exchange. The loss will then be recognized.

Under this same section losses between husband and wife are not recognized. However, in the case of McWilliams 5TC No. 73, the loss was allowed under the following circumstances. The husband sold the securities thru his broker. He then gave orders to the broker to buy the same quantity of stock for his wife's account. The Tax Court allowed the loss on the ground that it was not a direct transaction between husband and wife.

Another interesting case of a controlled situation appears in the Crown Cork 4 TC 19 Aff'd CCA-3, 1945. Here the parent company made a bona fide sale of certain property

to its subsidiary at a substantial loss. Section 24(b) does not specifically cover such a transaction unless either corporation is a personal holding company. The Tax Court denied the deduction on the basis that no economic loss had occurred. What the taxpayer once had in one pocket, it now had in another pocket. The disallowance of this loss has another aspect. The original basis is forever lost. If property costing $100,000 is sold for $10,000, no loss will be recognized under the above circumstances. When the purchaser resells to an outsider for $15,000—there is a recognized gain of $5,000 although there is an economic loss of $85,000 to the group.

An interesting situation existed in Gulf Shipbuilding Corp. Memo TC 6/28/45. A subsidiary company of the taxpayer owned depreciable property used in business, and the parent was engaged in war work and could use this property in its activities. It purchased the property from the subsidiary at a substantial profit to the latter and then sought a deduction for accelerated depreciation based on the cost to it. The subsidiary did no business for about a year after the sale and was thereafter dissolved. The taxpayer viewed the plan as two distinct transactions—one involving the sale and the other concerning the liquidation. The Tax Court, under the Dobson rule, held that the entire plan was in effect an outright dissolution of the subsidiary under 112 (b) (6) and that the basis of the assets in the hands of the subsidiary became the basis for the parent. Depreciation therefore was allowed on the original cost and not on the actual selling price, despite the fact that the subsidiary had already paid a tax on this profit.

This year taxpayers have seen the Gregory case applied in what many thought were "safe" transactions. These decisions affect recapitalizations and before any plan is adopted these cases should be carefully read and understood. In several instances taxpayers thought it more desirable for their corporations to have bonds or notes outstanding rather than preferred or common stock. Since interest is deductible and dividends are not it is obvious why the change was sought.

In three decisions this year, Adams 5 TC No. 40; Bazley 4 TC No. 108; and Heady Mem TC 7/28/45, the Tax Court held that the exchange of notes and bonds for stock was not a tax-free recapitalization, and the bonds or notes received by the stockholders constituted a taxable dividend to the extent that earned surplus existed. The Tax Court agreed that there was business purpose present, but it was the business purpose of the stockholders, not of the corporation. It stated that only where there is an actual benefit to the corporation will a tax-free recapitalization be recognized. For a case in point see Annis Furs 2 TC 1096 involving exchange of new 6% debentures for old 6½% preferred stock.

Ordinarily, when a creditor settles an obligation for less than face value and he is insolvent both before and after the deal, no gain is recognized. Our Second Circuit does not agree. In Fifth Avenue-14th Street Corp. CCA 2-1944, such gain was taxable under the following circumstances: The figures cited are not the actual ones but serve to illustrate the theory. The taxpayer's assets cost $50,000,—were worth $30,000 and were subject to mortgage bonds of $40,000. The taxpayer was able to buy $10,000 of participating certificates for $7,000, realizing a gain of $3,000, and its actual deficit was reduced from $10,000 to $7,000. The Court concluded that the taxpayer realized a gain of $500 and reasoned this way. The mortgage was worth 75% of face value. When it bought $10,000 face value for $7,000 it pur-

chased \$7,500 real value (75% of \$10,000) for \$7,000 and therefore had a taxable gain of \$500.

This is of course an exception to the American Dental Co. decision (318 US 322-1943) involving forgiveness of indebtedness. Taxpayers since 1939 had the option of avoiding the tax on such gain by complying with Section 22 (b) (9). The above case involved 1935, 1936, 1937, but it is important as an apparent limitation of the scope of the American Dental decision.

On item that requires careful planning is loss of equity in property through foreclosure, or sale for taxes. Such a loss is an ordinary loss but is deductible only in the year in which right of redemption expires. Thus there is control as to the year of deduction. If the loss is not sought this year, no further action on the part of the taxpayer is required. But if it is desired to take the loss in 1945 this result can be accomplished by having the taxpayer give a quit claim deed or release his right of redemption. The important point to remember is that no consideration must be received for this as that would make the transaction a sale or exchange and the loss a capital loss, not an ordinary loss. An ordinary loss may also be established by abandonment of title, but that becomes a factual matter which sometimes is difficult to prove. However, such losses have been allowed where properly substantiated.

That losses to be deductible must be real in the economic as distinguished from the legal sense was illustrated in Horne 5TC No. 27. The taxpayer owned a seat on the Coffee Exchange which cost him \$24,000 and he arranged a sale of his membership for \$1,000. A few days prior to the sale he bought another seat for approximately \$1,000. He claimed a \$23,000 loss. The Bureau disallowed it, claiming it came within the scope of Section 118 dealing with wash sales. The Tax Court upheld the Commissioner but on a different theory. The Court said it wasn't a wash sale because membership in an exchange is not a security. But it disallowed the loss as a sham since the taxpayer was in no worse economic position after the sale as he still owned one seat on the exchange. Actually the taxpayer is in a worse position because when he ultimately sells that seat his cost basis is \$1,000 not the original \$24,000.

An inequitable but probably correct technical decision was reached in the case of Maransky 5TC No. 46. The taxpayer required large quantities of wool in his manufacturing business and in connection with such activities bought wool futures. Before the futures came due he discovered that the wool was inferior and was not suited for his use. He therefore sold his futures at a loss of \$80,000 which he claimed as an ordinary loss. The Tax Court held it to be a capital loss. Here again is a situation where tax planning would have made a tremendous difference. If the taxpayer had accepted delivery of the wool and then immediately sold it, the loss would have been one in connection with his business operations and would have constituted on ordinary loss.

Another important case involving the use of tax control is Block v. Commissioner CCA 9-1945. This decision concerned the proper basis for cost of securities received in a reorganization. The general rule in these situations is that the number of shares received is divided into the total cost of the old stock and and an average price is arrived at which is to be used for determining gain or loss on subsequent sale of the new stock. The taxpayer in this situation made an attempt at actual indentification. He took the

lowest numbers of the old stock and matched them with the lowest numbers of the new stock. The Court held this was sufficient identification to make the average cost basis inapplicable in the circumstances. This is just one decision and I believe that in the situation where a taxpayer has securities that have been acquired at materially different prices, the safest plan would be to make an individual exchange of each certificate. There could then be no question of identification.

Recently the Supreme Court decided a case which strikingly sets forth the advantages of tax planning and which shows the dire results of lack of such planning. In Court Holding Co. (324 US 331-1945) the question before the Court was who sold the property—the corporation or the stockholders? The facts were that the taxpayer corporation negotiated for and made an oral agreement with respect to the sale of its property. Its counsel advised it that this was not the best way to consummate the deal as the corporation would be subject to a tax on the profit and the stockholders would also pay a capital gains tax on the net proceeds at the time of liquidation of the corporation. Accordingly the corporation was first dissolved, the property was transferred to the stockholders as a liquidatng dividend and a written contract for the sale of the property was made by the stockholders. The Bureau and the Tax Court held the corporation taxable on the profit; the Florida Circuit Court reversed, and the Supreme Court again reversed, sustaining the Commissioner. The Supreme Court concluded that the stockholders were acting as agents of the corporation and that the gain was the corporation's.

In many instances such an unfortunate result may be avoided where the purchaser is a taxpayer other than a corporation. In closely held corporations it is sometimes difficult to definitely determine whether negotiations are carried on by the officers as employees of the corporation or in their own behalf as stockholders. In such situations the safest procedure is for the officers to arrange to sell their stock in the corporation based on the market value of the corporation's property. There then can be no question as to who made the sale. As soon as the purchaser acquires the stock he can dissolve the corporation and the basis to him will be the fair market value of the property received which should result in neither gain nor loss to him since that is presumably what he paid for the stock.

This procedure may also be effectively used with a corporate purchaser where the assets of the selling corporation have depreciated in value. The purchasing corporation could then dissolve its subsidiary under 112 (b) (6) and acquire the higher basis of the assets. For example, X corporation owns real estate costing it $500,000 which is now worth $300,000. The stockholders sells their stock to Y corporation for $300,000. Subsequently Y corporation dissolves X corporation. For purposes of gain or loss and depreciation, the basis of the property in the hands of Y corporation is not the purchase price $300,000 but X's cost $500,000. When the property has appreciated in value, the purchase of stock by a corporate taxpayer is not recommended.

In view of the tremendous real estate activity this year there is one matter that should receive careful attention, and that is the proper tax treatment of real estate tax apportionment as between buyer and seller. It is possible for the seller to deduct the entire tax even though

he paid none of it, and for the purchaser to deduct the entire tax despite the fact that he assumed only part of it, and the reverse is also true. The Supreme Court recently in Magruder v Supplee (316 US 394-1942) held that the purchaser of real estate who pay taxes after date of acquisition is not entitled to any deduction for taxes which either were a pre-existing lien or a personal liability of the seller at the time of sale. As a glaring example of the inequitable results that flow from this decision suppose that a taxpayer purchased property on January 31, 1945 and that the lien for tax accrued on January 1, 1945. The purchaser would assume and pay 11/12ths of the 1945 tax but in accordance with the above decision he would not be entitled to any deduction. The amount paid would be considered additional cost of the property.

On the other hand, the seller although assuming and paying only 1/12th of the tax is entitled to the entire tax as a deduction and he must then add the other 11/12ths to the selling price. A purchaser made effective use of this doctrine in LeRoy 4 TC 9. In this case the tax was not a lien and consequently the entire year's tax paid by the purchaser was allowed in full although he had possession of the property for only three months. The taxes for the nine months were credited to the purchase price.

Miscellaneous Items

There are many other situations in which "tax control" can play a useful part. Time does not permit of a detailed discussion of them but no discussion would be complete without at least a reference to them.

Loss allowed stockholder on surrender of his stock to corporation (Miller 45 BTA 292).

Sale or exchange of property used in business. Taxpayer has choice of taxable or nontaxable result.

Redemption of note bought at discount is ordinary gain. If note is sold before redemption it is capital gain.

Recoveries under Section 22(b) (12) and T.D. 5454 generally not taxable.

Dividends in kind paid in property which has appreciated in value do not result in gain to corporation. (General Utilities Operating Co. 296 US 200). If assets have depreciated they should be sold and proceeds distributed as dividend.

There is no gain realized on property which has appreciated in value and which is used to make an allowable contribution. The market value is the amount of the deduction. Conversely, if the property has depreciated it should be sold and contribution made with proceeds.

For substantial taxpayers use of irrevocable charitable insurance trust is recommended. Insurance premiums are deductible as contributions, and corpus is not part of grantor's estate.

Compensation for services rendered over a long period may be favorably taxed under Section 107.

In Florida, Maryland, Michigan, Missouri, New York and Pennsylvania, property may be held as tenants by the entirety and the income is divided equally between the spouses.

Do not overlook special treatment of non-business bad debts as short-term capital losses, and favorable treatment of partial bad debt deductions.

Depreciation may be computed on other than straight line methods. The Bureau has allowed depreciation up to 150% of the amount determined by straight line method, when declining method is used.

On the sale of depreciable property the basis will be adjusted for

depreciation allowed or allowable, whichever is higher. If the taxpayer failed to take sufficient depreciation in prior years, it is possible that an apparent loss may be converted into an actual gain.

When property is bought on the installment plan the interest element should be indicated separately. If possible each installment should show the interest as a separate item.

Stock transfer taxes are deductible as non-business expenses. They should not be treated as an offset to the sales price.

Section 125 permits deduction as ordinary loss of amortization of bond premiums. Otherwise loss on redemption is a capital loss.

Benefits may be obtained from proper application of election as to treatment of carrying charges set forth in Section 24 (a) (7).

Payment for cancellation of lease is deductible in full when paid.

Rents received in advance even on the accrual basis is income in the year in which received.

Depreciation or amortization is spread over term of lease without regard to renewal periods if there was no certainty that renewal option involved would be exercised.

Yearly increment of interest on U.S. Savings Bonds may be accrued even by cash basis taxpayers. When bonds are in names of children or dependents who have no income, accrual can be made without payment of tax currently or at maturity.

Exempt income is disregarded in determining if dependent has income of $500 or more. However, it is considered in determining if the taxpayer furnished more than one half of support.

Husband is not entitled to surtax exemptions for certain of wife's relatives on a separate return, but would be allowed such exemptions on a joint return even if wife has no income.

Provision for an expense deducted in prior years and now no longer found necessary is income in the year such reserve or liability is credited to profit and loss or surplus. Transfers of this nature should not be made in 1945 except under unusual circumstances.

And finally a few words about life insurance. If the decedent exercised incidents of ownership or paid the premiums directly or indirectly, the proceeds are taxable as part of the decedent's estate. If the beneficiary pays the premiums out of his own funds the proceeds are not taxable.

When proceeds of life insurance are paid in fixed installments including interest element, the interest element is not taxable income to the beneficiary when the election for such mode of payment was made by the decedent. The Tax Court and our Second Circuit have also applied this rule even when the beneficiary made the election. (Katherine Pierce CCA 2-1944 Aff'd TC 832). The Commissioner does not agree.

I have studiously avoided all reference to family partnerships. The law on this subject is in a state of flux. For a splendid discussion of this subject see Professor Harrow's article in the October 1945 issue of the New York Certified Public Accountant.

Important Aspects of Refund Claims and Suits for Refund

By SAMUEL JOYCE SHERMAN, C.P.A.

IT is a serious mistake to regard the claim for refund and the suit for refund as separate, unrelated activities. Not only is the claim a necessary prelude to the suit, but it is the very foundation upon which the successful prosecution of the suit depends.

Too many claims are faultily, superficially and carelessly prepared. The case books are full of decisions dismissing actions for the recovery of tax overpayments because of the insufficiency of the claims filed. Of what avail is it to have a meritorious claim if, in the end, the claimant is not permitted to prove it in court because the claim filed fails to state facts, grounds and evidence essential to recovery? The preparation of a tax refund suit should properly begin with the filing of a valid, sufficient and timely claim for refund.

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The attitude of the courts has noticeably hardened toward claimants who do not comply with the requirements of the statutes and the Treasury Regulations as to the form and content of refund claims. Pleas of waiver and estoppel are no longer viewed with the easy tolerance that marked the attitude of the Supreme Court some eighteen years ago, when it declared in the leading case of *Tucker v. Alexander*:[1]

> "* * * The statute and the regulations must be read in the light of their purpose. They are devised not as traps for the unwary, but for the convenience of government officials in passing upon claims for refund and in preparing for trial. Failure to observe them does not necessarily preclude recovery. * * * If the Commissioner is not deceived or misled by the failure to describe accurately the claim, as obviously he was not here, it may be more convenient and decidedly in the interest of an orderly administrative procedure that the claim should be disposed of upon its merits on a first trial without imposing upon government and taxpayer the necessity of further legal proceedings. We can perceive no valid reason why the requirements of the regulations may not be waived for that purpose."

Whether it be wartime conditions and the more urgent need to protect the government revenues or a mani-

[1] 275 U. S. 228 (1927).

festation of judicial impatience with defective claims pressed before the courts, the pendulum seems to have swung completely back. Thus, in the *Angelus Milling Co.* case,[2] affirmed by the Supreme Court in May of this year, Circuit Judge Learned Hand made this trenchant comment:

> "A taxpayer who files a claim which does not conform with the statute, takes his chances that in the end the Commissioner may reject it, no matter how complaisant he may appear to be. * * * It makes no difference to the taxpayer what was his mistake; in either case he awakes to learn that it is never safe to put his trust in officials. * * * The result is often extremely harsh, as this case shows; but he who deals with the government must dot his I's and cross his T's; and if he assumes that he may rely upon ordinary rules which apply as between individuals, he is doomed to disappointment."

And Mr. Justice Frankfurter, speaking for the Supreme Court, added that the "courts should not unduly help disobedient refund claimants to slip through" the tight net of the Treasury Regulations fashioned for the protection of the revenues.

Refund Procedures

There are three ways in which a taxpayer may secure a refund (or a credit against an unpaid liability for other taxes), viz:

(1) *By administrative action*—Under Code Section 322 (a), the Commissioner has the authority to refund an overpayment or allow a credit therefor, on his own initiative, even though the taxpayer has not filed a claim therefor. The Commissioner has exercised this power in many instances where as a result of an examination of the taxpayer's return and/or his books, the Bureau has discovered an overpayment, but voluntary refunds and credits are not the rule. Under Code Section 322 (b), the Commissioner's authority to grant refunds or credits, where no claim has been filed therefor, is limited to the portion of the tax paid within three years before the allowance of the credit or refund and, under no circumstances, can the Commissioner make a refund or credit after the taxpayer's right to file a claim is barred by the expiration of the statute of limitations. Obviously, the safest course for a taxpayer to pursue is to file a claim for refund in all cases.

(2) *By suit*—If the Commissioner has rejected the claim or has failed to take action on it within six months after its filing, the taxpayer's remedy is to bring an action in court for recovery of the taxes overpaid. The filing of a proper claim for refund or credit within the proper period of limitations is a condition precedent to the maintenance of such an action.

(3) *By legislative action*—Refunds may also be made through Congressional action. Either House in which a bill is pending for the payment of a claim against the United States may refer it to the Court of Claims for a report on the facts and conclusions as to the amount legally or equitably due from the United States to the claimant.[3] Legislative relief is usually slow and generally is granted only in unusual cases where the claimant cannot obtain relief through the usual remedies provided by law.

Importance of Claim For Refund

The filing of a proper and timely claim for refund is important for four main reasons:

(1) The statute forbids the Commissioner from making a credit or refund after the expiration of the period of limitation for the filing of a claim for refund.[4]

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[2] 65 S. Ct. 1162 (1945), aff'g 144 F. (2d) 469 (C. C. A. 2, 1944).
[3] Judicial Code, Sec. 151, 28 U. S. C. A. §257.
[4] I. R. C. Sec. 322 (b) (1).

(2) The filing of a claim for refund is an indispensable prerequisite to a suit in court.[5]

(3) Recovery can be had only upon the grounds specified in the refund claim.[6]

(4) In a tax refund suit, the claimant may be confined to the facts and evidence submitted in his claim for refund.[7]

Essentials of a Valid Claim For Refund

The statutes and the Treasury regulations, as construed by the courts, set up certain criteria for the preparation and filing of a proper claim for refund. A brief summary of these requirements follows:

(A) Form of Refund Claim

(1) It must be in writing[8] and under oath.[9]

(2) It should be filed on the prescribed Treasury form (Form 843).[9]

(3) A separate claim should be filed for each taxable year or period.[9]

(4) It should be verified by the taxpayer or his duly appointed agent. If signed by another than the taxpayer, there must be submitted with the claim proper evidence of authority.[9]

(B) Content of Refund Claim

(1) It should be set forth in detail each ground upon which refund is claimed.[9]

(2) It should set forth *facts* sufficient to apprise the Commissioner of the exact basis of the claim for refund.[9]

(3) It should set forth all the *evidence* which the claimant intends to offer in court in support of his suit for refund. (This is a counsel of caution based on the rule of the *Samara* case discussed *infra*.)

(C) Claim Must Be Filed by Proper Party

(1) Ordinarily, the proper person to file a claim for refund is the taxpayer or his legal representative.

(2) The question as to the proper party-claimant has arisen in connection with minors, dissolved corporations, affiliated corporations, assignees, creditors, subrogees, where one person pays the tax for another, and other special situations.

(D) Where the Refund Claim Must be Filed

(1) The claim, together with appropriate supporting evidence, must be filed in the office of the Collector for the district in which the tax was paid.[10]

(E) When Refund Claim Must Be Filed

(1) A claim for refund of income taxes must generally be filed within three years after the return was filed or within two years after the tax was paid, whichever expires later.[11] For taxable

[5] I. R. C. Sec. 3772 (a) (1).
[6] Reg. 111, Sec. 29.322-3; U. S. v. Andrews, 302 U. S. 517 (1938).
[7] See discussion of doctrine of *Samara* case, at pages , infra.
[8] Wrightsman Petroleum Co., et al. v. U. S., 35 F. Supp. 86 (Ct. Cls., 1940).
[9] Sec. 29.322-3, Reg. 111.
[10] Sec. 29.322-2, Reg. 111.
[11] I. R. C. Sec. 322 (b) (1).

years beginning after December 31, 1941, a return filed in advance of the due date is considered as filed on the due date. Likewise, advance payments are considered as made on the due date of payment or the due date of the first installment thereof.[12]

(2) Special provisions dealing with time limitations on the filing of refund claims apply to situations where the taxpayer has executed a waiver extending the period of assessment,[13] claims relating to bad debts and worthless securities,[14] overpayments found by the Tax Court,[15] war losses,[16] claims arising from inconsistent position adopted with respect to prior treatment of an item of income, deduction or credit,[17] etc.

Two things should be borne in mind in connection with the requirements outlined above. They were reiterated by the Supreme Court in the *Angelus Milling Co.* case[18] decided in the spring of this year: (1) Statutory requirements, such as the statute of limitations on the filing of refund claims, must be strictly observed; they are "beyond the dispensing power of Treasury officials". (2) While the Commissioner may waive literal compliance with the formal and procedural requirements set forth in the Treasury regulations, he is under no constraint to do so; on the contrary, "he may insist upon full compliance with his regulations".

Informal Refund Claims:

An informal claim may satisfy the statutory requirements if it is "more than a protest or a statement of an intention to file a claim later".[19] An informal claim is one that fails to comply with the formal requirements of the statute and regulations, such as making out the claim on the prescribed form, executing it under oath, setting forth the specific grounds and supporting facts, etc. Recognition of informal claims rests on the principle that the Commissioner has waived his right to object to the form of claim, its lack of particularity, or other formal defects.[20] However, not every informal claim will stand up as a sufficient claim in the form originally filed or be susceptible to amendment after the expiration of the statutory period for the filing of a claim.

Claims held to be insufficient—An informal claim for refund must at least allege overpayment of taxes, the amount thereof, the grounds upon which refund is claimed, and a demand for the return of the overpaid taxes.[21] Here are a few of many informal claims that failed to meet the minimal standards of sufficiency:

A letter which contained neither a statement of overpayment in any spe-

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[12] I. R. C. Sec. 322 (b) (4), as amended by Rev. Act of 1942, Sec. 169 (a).

[13] I. R. C. Sec. 322 (b) (3), added by Rev. Act of 1942, Sec. 169 (a).

[14] I. R. C. Sec. 322 (b) (5), as amended by Rev. Act of 1943, Sec. 504.

[15] I. R. C. Sec. 322 (d), as amended by Rev. Act of 1942, Sec. 169 (b).

[16] I. R. C. Sec. 3804, added by Rev. Act of 1942, Sec. 507 (a).

[17] I. R. C. Sec. 3801, added by Rev. Act of 1938, Sec. 820.

[18] 65 S. Ct. 1162 (May 21, 1945) and cases cited therein.

[19] Kales v. U. S., 115 F. (2d) 497 (C. C. A. 6, 1940), aff'd 314 U. S. 186 (1941).

[20] Kales v. U. S., supra; Tucker v. Alexander, 275 U. S. 228 (1927); U. S. v. Andrews, cited at note , supra.

[21] Julia A. Forhan v. Com'r, 45 B. T. A. 799 (1941).

cified amount nor a demand for refund.[22]

A letter to the Commissioner stating that the taxpayer would file a claim for refund later.[23]

A mere declaration by the taxpayer that the claim was filed "to protect all possible legal rights of the taxpayer," without setting forth facts as to the amount or nature of the claim.[24]

An amended return unsupported by a claim.[25]

A notation typed in on the tax return, reading "paid under protest and refund demanded" was held to be deficient both as to form and lack of certainty and hence did not constitute a valid informal claim which could be amended after the expiration of the statute of limitations.[26]

A mere protest against the deficiency asserted by the Commissioner.[27]

A claim for refund on Form 843 which does not state any grounds or facts as a basis for recovery.[28]

A request for a ruling by the Commissioner.[29]

A closing agreement.[30]

An appeal to the U. S. Board of Tax Appeals with respect to an item disallowed by the Commissioner, on which the claim for refund is predicated.[31]

Claims held to be sufficient—A waiver executed by a taxpayer was held to be a valid informal claim which could be perfected by an amendment after expiration of the statutory period of limitation, when the waiver was filed at the Commissioner's request in response to a communication notifying the taxpayer of a determination of an overassessment and such waiver was accepted and treated by the Bureau as an informal claim.[32]

Where, during the pendency of litigation over deficiencies in prior years, the taxpayer informed the Commissioner that the same question was involved in tax liability for later years, it was held that the taxpayer had filed informal claims by writing on the back of two checks delivered to the collector "this check is accepted as paid under protest pending final decision of the higher courts." A formal refund claim subsequently submitted after expiration of the statutory period of limitation was held to be a perfection of the informal claim. The court observed that refund claims, whether formal or informal, are not required to be filed with the Commissioner and the Collector's failure to forward the claim to the Commissioner or advise him of the contents thereof did not render the claim void or ineffectual.[33]

A letter written by the taxpayer to the collector and lodged with the Commissioner, challenging the validity of a jeopardy assessment on the ground that a valuation of stock determined by the Commissioner's predecessor in office was unalterable and asserting alternatively a right to refund in the event that the earlier valuation of the stock should be set aside

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[22] Carr Peterson v. U. S., 24 A. F. T. R. 1233 (D. C., Okla., 1939); Carver v. U. S., 27 F. Supp. 608 (Ct. Cls., 1939); International Arms & Fuze Co. v. U. S., 37 F. (2d) 771 (Ct. Cls., 1930).

[23] Ordway, Ex'n v. U. S., 37 F. (2d) 19 (C. C. A. 2, 1930).

[24] U. S. v. Felt Tarrant Mfg. Co., 283 U. S. 269 (1931).

[25] Mim. 2764, 4 C. B. 332 (1921).

[26] Lincoln Cotton Mills Co. v. U. S., 53 F. Supp. 309 (Ct. Cls., 1944).

[27] Julia A. Forhan v. Com'r, cited at Note 21, supra; Stimpson Computing Scale Co. v. Lucas, 39 F. (2d) 473 (D. C. Ky., 1927).

[28] U. S. ex rel. Endicott et al. v. Mellon, 39 F. (2d) 505 (C. A. D. C. 1930).

[29] Baltimore & Ohio R. R. Co. v. U. S., 260 U. S. 565 (1923).

[30] McLaughlin v. Dean Witter & Co., 69 F. (2d) 259 (C. C. A. 9, 1934).

[31] Stimpson Computing Scale Co. v. Lucas, cited at Note 27, supra.

[32] Bonwit Teller & Co. v. U. S., 283 U. S. 258 (1931).

[33] Night Hawk Leasing Co. v. U. S., 18 F. Supp. 938 (Ct. Cls., 1937).

by the Bureau, and stating that "if for any reason a revaluation shall be had" taxpayer "will insist" that the stock was greatly undervalued, that the tax paid was correspondingly excessive, and "will claim the right to a refund" to the extent of such excess, was held to be a valid informal claim. An amended formal claim, subsequently filed after expiration of the statutory period of limitation, was held to be merely a perfection of the timely informal claim previously filed. Despite the fact that the informal claim was couched in the future tense, the Court did not consider it to be in the nature of a declaration to assert a claim in the future, but "as an assertion of a present right."[34]

Amendment of Claim

It frequently happens that new grounds or facts are discovered, which either entitle the taxpayer to a greater refund than that originally demanded or further sustain the claim already filed. The question considered here is: When may a claim for refund be amended?

(A) *Amendment prior to expiration of statutory period*

A taxpayer may amend his original claim, *as a matter of right*, at any time before the expiration of the statutory period applicable to the filing of refund claims. The amendment may take the form of an amended or supplemental claim or a new claim. The statute does not limit the number of claims that may be filed.

(B) *Amendment after expiration of statutory period*

The difficulty encountered in most cases is where the taxpayer attempts to file an amended claim after the statute of limitations has expired. The question turns on whether or not the original claim filed was *general* or *specific* in setting forth the grounds and facts upon which recovery is sought and the consequent scope of the matters requiring investigation by the Commissioner. The rule has been stated by the Supreme Court in a leading case,[35] as follows:

> "Where a claim which the Commissioner could have rejected as too general, and as omitting to specify the matters needing investigation, has not misled him but has been the basis of an investigation which disclosed facts necessary to his action in making a refund, an amendment which merely makes more definite the matters already within his knowledge, or which, in the course of his investigation, he would naturally have ascertained, is permissible. On the other hand, a claim which demands relief upon one asserted fact situation, and asks investigation of the elements appropriate to the requested relief, cannot be amended to discard that basis and invoke action requiring examination of matters not germane to the first claim."

The application of this rule to concrete cases decided by the courts will now be illustrated.

(1) *Particularizing amendments of general claims*—The claim filed by the taxpayer in *U. S. v. Memphis Cotton Oil Co.*[36] was certainly general enough. All that it set forth was the amount of tax paid, the correct amount of tax alleged to be due, and the difference claimed to have been overpaid. The Commissioner could have rejected the claim for failure to state the facts and grounds upon which the refund was demanded, but he didn't. Instead, he made a complete investigation and audit of the taxpayer's books for the taxable years

[34] U. S. v. Kales, 314 U. S. 186 (1941).
[35] U. S. v. Andrews, 302 U. S. 517 (1938).
[36] 288 U. S. 62 (1933).

involved, which confirmed the fact that the taxpayer had overpaid its taxes. Thereafter, the Commissioner notified the taxpayer that he was going to reject the claim for failure to specify the grounds for refund as required by the regulations. However, before the Commissioner issued the formal notice of rejection, but after the statute of limitations had run, the taxpayer filed an amended claim in which the facts were set forth in detail. The Supreme Court held that the amended claim was properly filed. The amendment did not constitute a new claim; it merely perfected the old claim by filling in the gaps. Since the Commissioner considered the old claim on the merits and had made an audit of the taxpayer's books coextensive with the generality of the old claim, he could not object to the amendment curing the formal defects of the old claim.

The *Memphis Cotton Oil Co.* case, *supra,* therefore, stands for the rule that a general claim timely filed may be amended after the period of limitation by specifying the grounds, if such amendment is made *prior* to final rejection of the claim by the Commissioner.[37] However, once the claim has been rejected and, therefore, is not in existence as a claim before the Commissioner, it cannot be amended after the expiration of the statute of limitations.[38]

In *Baltimore & Ohio R. R. Co. v. U. S.,*[39] the taxpayer's claim for refund was specific as to certain items of which the taxpayer had knowledge, and general as to other items with respect to which both the taxpayer and the Commissioner expected to receive additional definite information upon completion of the examination of the taxpayer's books and records by the Bureau of Internal Revenue then in progress Upon being advised of the results of the Bureau's examination, the taxpayer filed amendments of its original claim setting out additional specific items disclosed by such examination. Under the peculiar facts of the case, the amendments were held to be proper even though filed after the statutory period for filing. Lest the decision be mistaken for a blanket endorsement of the practice of perfecting careless and loosely worded refund claims by later untimely amendments, the court said, "We do not mean to be understood as saying that a taxpayer may play fast and loose with its claims for refund. . ."

(2) *Broadening amendments with respect to specific claims*—The second part of the rule enunciated by the Supreme Court in the *Andrews case,*[40] *supra,* may be illustrated by the facts of that case. There, the taxpayer in her original claim for refund demanded recovery on the specific ground that she had failed to take deductions on her return for losses sustained on two worthless stocks. Subsequently, and after the statutory period of limitation, she filed an amended claim seeking recovery in a larger amount on the ground that an item, reported on the tax return as an ordinary dividend, should have been treated as a capital gain. The amendment was disapproved by the court as an untimely attempt to set up an entirely new ground for recovery or, in terms of legal pleading, a new cause of action. It has been held that the Commissioner lacked the statutory authority to consider such an amendment changing the cause of action, after the expiration of the period of limitation.[41]

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[37] See U. S. v. Factors & Finance Co., 288 U. S. 89 (1933); Moore Ice Cream Co., Inc. v. Rose, 289 U. S. 373 (1933).

[38] Elbee Chocolate Co. v. U. S., 63 F. (2d) 773 (C. C. A. 2, 1933).

[39] 38 F. Supp. 83, aff'd 124 F. (2d) 344 (C. C. A. 4, 1941).

[40] Citation at Note No. 35, *supra.*

[41] U. S. v. Henry Prentiss & Co., 288 U. S. 73 (1933); U. S. v. Garbutt Oil Co., 302 U. S. 528 (1938).

(3) *Minor Amendments* — Amendments made after the expiration of the statutory period are permissible, if they merely fill in minor details or correct mathematical errors, which the Commissioner would ordinarily discover in the course of his investigation of the facts set forth in the original claim. Thus, it was held that an amendment requesting alternative relief on the basis of facts fully disclosed in the original claim was proper.[42] Frequently, refund claims demand the return of a specified amount "or such greater sum as is legally refundable." This "catch-all" phrase will support recovery of an amount greater than the specified sum *only* on the grounds set forth in the claim.[43] However, it will not validate an amendment after the bar of the statute to include entirely different grounds from those stated in the original claim.[44]

Grounds Required to Be Stated In the Refund Claim

Section 3772(a)(1) of the Internal Revenue Code provides that no suit or proceeding can be maintained in any court for the recovery of an overpayment of tax "until a claim for refund or credit has been duly filed with the Commissioner according to the provisions of law in that regard and the regulations of the Secretary established in pursuance thereof."

The statute is silent as to the form and content of a refund claim. However, the Treasury Regulations provide, *inter alia*:[45]

"The claim must set forth in detail and under oath each ground upon which a refund is claimed and facts sufficient to apprise the Commissioner of the exact basis thereof."

It is of the utmost importance that the refund claim set forth each and every ground upon which recovery is claimed, for three reasons:

(1) No refund or credit will be allowed by the Commissioner after the expiration of the statutory period of limitation for the filing of a claim for refund except upon one or more of the grounds set forth in a claim filed prior to the expiration of such period.[46]

(2) A refund claim cannot be amended after the expiration of the statutory period of limitation to set up new grounds for recovery, unless it be clearly shown that the Commissioner has waived the requirements of the regulations as to the formality and particularity with which the grounds for refund are required to be stated.[47]

(3) No recovery can be had in a suit for tax refund on grounds other than those stated in the claim for refund.[48]

It has been held that a taxpayer may state as many grounds for refund as he wishes regardless of consistency, provided facts are disclosed on which

[42] Bemis Bros. Bag Co. v. U. S., 289 U. S. 28 (1933).
[43] F. W. Woolworth & Co. v. U. S., 91 F. (2d) 973 (C. C. A. 2, 1937); Endicott, et al., Exec. v. Mellon, 39 F. (2d) 505 (App. D. C. 1930).
[44] U. S. v. Andrews, cited at Note 35, supra; Guantanamo Sugar Co. v. U. S., 38 F. supp. 252 (Ct. Cls. 1941).
[45] Sec. 29.322-3, Reg. 111.
[46] Idem.
[47] U. S. v. Andrews, 302 U. S. 517 (1938); U. S. v. Garbutt Oil Co., 302 U. S. 528 (1938).
[48] U. S. v. Felt & Tarrant Mfg. Co., 283 U. S. 269 (1931); Real Estate-Land Title & Trust Co. v. U. S., 309 U. S. 313 (1940); Red Wing Malting Co. v. Willcuts, 15 F. (2d) 626 (C. C. A. 8, 1926).

the Commissioner may act.[49] Accordingly, the safest and most advisable course to pursue is to set out in the claim every possible ground for recovery that may be urged.

While it is settled on the highest authority that literal compliance with the requirements of the Treasury regulations as to the form and particularity of the claim may be waived by the Commissioner, especially where he has not been misled by the claim as filed, and has had full opportunity to investigate the merits of the claim,[50] however, recent court decisions emphasize the hazard of relying too strongly on waiver unless it can be clearly established by unmistakable proof. Thus, in the *Angelus-Milling Co.* case[51] decided by the Supreme Court on May 21, 1945, Mr. Justice Frankfurter stated:

> "Since, however, the tight net which the Treasury Regulations fashion is for the protection of the revenue, courts should not unduly help disobedient refund claimants to slip through it. The showing should be unmistakable that the Commissioner has in fact seen fit to dispense with his formal requirements and to examine the merits of the claim. It is not enough that in some roundabout way the facts supporting the claim may have reached him. The Commissioner's attention should have been focussed on the merits of the particular dispute. The evidence should be clear that the Commissioner understood the specific claim that was made even though there was a departure from form in its submission. We do not think that the petitioner has made out such a case here."

The Tax Court, in a recently decided case,[52] observed; "The fact that the Commissioner was patient with the petitioner and had various conferences in an effort to obtain additional information does not show that the Commissioner waived the defects in this claim."

Facts and Evidence Required to Be Submitted in Support of The Refund Claim

Until quite recently, tax practitioners were under the impression that a claim for refund was adequate if it presented sufficient facts to apprise the Commissioner of the grounds upon which the claim was based, so that he could intelligently and expeditiously investigate and pass upon the merits of the taxpayer's claim. While it was well recognized that a claimant could not maintain an action in court upon an entirely different and distinct ground from that presented to the Commissioner, no one thought for a moment that the claimant would be confined in court to the facts and evidence submitted to the Commissioner prior to rejection of his claim. There was ample supporting authority for these views. Referring to the Treasury regulation quoted in the preceding section, it was said in *Snead, Collector v. F. H. Elmore*:[53]

> "This does not mean that the claim for refund must have contained all the evidence or argument that is offered in the suit, but it must have indicated not only the amount claimed but the substantial

[49] Kales v. U. S., 115 F. (2d) 497 (C. C. A. 6, 1940), aff'd 314 U. S. 186 (1941); Reynolds v. McMurray, 77 F. (2d) 740 (C. C. A. 10, 1935); Ferguson v. U. S., 2 F. Supp. 1012 (Ct. Cls., 1933).

[50] Tucker v. Alexander, 275 U. S. 228 (1937). In this leading case on the point stated in the text, note that the waiver was expressly stipulated by Government counsel in open court.

[51] Angelus Milling Co. v. Com'r., 65 S. Ct. 1162.

[52] Vica Company v. Com'r., 5 T. C. No. 61 (July 31, 1945).

[53] 59 F. (2d) 312 (C. C. A. 5, 1932); see also Paul Jones & Co. v. Lucas, 33 F. (2d) 907 (D. C., Ky., 1929), Fidelity & Columbia Trust Co. v. Lucas, 7 F. (2d) 146 (D. C., Ky., 1925).

grounds on which illegality is asserted and the general facts supporting the grounds, so that they may be fully investigated."

The faith reposed in this seemingly well settled principle was shattered by the startling doctrine announced in 1942 by the Circuit Court of Appeals for the Second Circuit in *Samara v. U. S.*,[54] that a claimant would be confined not only to the grounds set forth in his claim but also to the facts and evidence presented to the Commissioner prior to rejection of his claim.

The conclusion reached in the *Samara* case was eminently fair; it is the rationale of the decision that is so disturbing in its implications. The claim in that case demanded a refund of processing taxes paid under the Agricultural Adjustment Act invalidated by the Supreme Court in 1936.[55] The claim filed was palpably insufficient in that it failed to furnish the information and margin data required by the Treasury Regulations and the printed instructions on the form. In addition to setting forth the several tax payments making up the amount claimed, the taxpayer merely alleged that he bore the burden of the tax, which was nothing more than a legal conclusion unsupported by any facts.

The Commissioner displayed exemplary patience with the taxpayer in the *Samara* case. He sent two letters to the taxpayer pointing out the insufficiency of his claim and suggesting various types of evidence that the taxpayer should submit to substantiate his claim. The taxpayer paid no heed to the Commissioner's letters. Thereafter, the Commissioner rejected the claim and the taxpayer brought suit in the District Court for recovery on his claim. In approving the dismissal of the taxpayer's suit, the Circuit Court stressed the taxpayer's deliberate disregard of the Commissioner's repeated requests for additional information and concluded with the observation:

> "There is certainly no hardship in applying such ruling in the case at bar, for the plaintiff was repeatedly warned by the Commissioner's letters."

Other courts, dealing with the same problem posed by the *Samara* case, have reached a diametrically opposite conclusion to that enunciated by the Circuit Court of Appeals for the Second Circuit. Thus, ten days before the *Samara* case was decided, the Circuit Court of Appeals for the Third Circuit stated in *Bethlehem Baking Co. v. U. S.*:[56]

> "While it is the duty of a claimant to present a formal claim and to endeavor by sufficient proof to satisfy the Commissioner as to its merit, he should not be barred from presenting further evidence in support of the same claim in a suit for refund after rejection by the Commissioner."

However, the tide seems to be running strongly against the taxpayer. The Second Circuit Court has expressly disapproved the holding of the Third Circuit Court in the *Bethlehem Baking Co.* case, *supra*, and in 1945 it dismissed three complaints in tax refund suits.[57] The Tax Court has elected to follow the rule of the Second Circuit Court in the *Samara* case and in 1945, it dismissed petitions in four cases; three for refunds of pro-

[54] 129 F. (2d) 594 (C. C. A. 2, 1942), rev'g 39 F. Supp. 880.

[55] U. S. v. Butler, 297 U. S. 1 (1936).

[56] 129 F. (2d) 490 (C. C. A. 3, 1942); see also Hutzler Bros. v. U. S., 33 F. Supp. 801 (D. C., Md., 1940); Bullock's, Inc. v. U. S., 43 F. Supp. 861 (D. C., Cal., 1941); Ney et al v. U. S., 33 F. Supp. 554 (D. C., Va., 1940); Bricker Baking Co. v. Rothensies et al; 46 F. Supp. 742 (D. C., Pa., 1942).

[57] Louis F. Hall & Co., Inc. v. U. S., 148 F. (2d) 274 (C. C. A. 2, 1945); London Weatherproofs, Inc. v. U. S., 148 F. (2d) 341 (C. C. A. 2, 1945); David Usdan et al, Ex'rs v. U. S., F. (2d) (C. C. A. 2, 1945).

cessing taxes,[58] and the fourth, an application for relief under Section 722 of the excess profits tax law.[59] In the *Blum Folding Paper Box Co.* case,[60] the Tax Court declared:

> "The taxpayer may not, as here, file a superficial claim, leaving the Commissioner in ignorance of the possible factual support for the claim, and then, after the resulting disallowance, come forward for the first time with the supporting statement of facts. That information is not a part of the application and consideration of it is beyond the scope of review by the Tax Court."

Of significance, in every one of the aforementioned cases in which the taxpayer was precluded by the court from offering evidence not previously submitted to the Commissioner, the claim for refund was grossly inadequate and insufficient on its face, or the claimant wilfully disregarded the Commissioner's repeated requests for additional information in support of the claim and deliberately withheld from the Commissioner information essential to a fair consideration of the claim on the merits, or the claimant attempted to introduce evidence based on new and different grounds than those set forth in the claim for refund.

The last word on the rule of the *Samara* case has not yet been uttered. The doctrine is still in its developmental stage. Thus far the rule has been applied in extreme cases where the harshness of the result was perhaps justified by the glaring insufficiency of the claims filed and the flagrant disregard by the claimant of the Commissioner's regulations and requests for additional information. In cases where the claimant has filed an informative claim for refund and the Commissioner was fully apprised and investigated the facts, grounds and merits of the claim, it is reasonable to expect that the courts will mitigate the harshness of the rule. Bounds may be set upon the broad sweep of the rule with respect to corroboratory evidence, with respect to contentions and facts presented by the claimant to representatives of the Commissioner in supplementation of the formal claim filed, and with respect to rebuttal evidence offered by the claimant to explain and overcome doubts cast upon the claimant's affirmative case by facts and evidence introduced by the Commissioner at the trial.

This much is quite clear. A claimant can expect little tenderness or consideration from the courts unless he demonstrates good faith, candor and cooperativeness in making available to the Commissioner the material facts upon which his claim rests.

Credit of Overpayments Against Barred Deficiencies

General Rule — The Commissioner may not credit an overpayment of one year against a barred deficiency for another year. This prohibition is contained right in the law.[61] In *McEachern v. Rose,*[62] the Supreme Court said:

> "These provisions preclude the government from taking any benefit from the taxpayer's overpayment by crediting it against an unpaid tax whose collection has been barred by limitation."

However, the rigidity of the statutory rule has been tempered to some extent by court decisions which have invoked the equitable principles of recoupment and estoppel. Important exceptions to

[58] Athens Roller Mills v. Com'r. T. C. Memo Decision (Jan. 11, 1945); Cherokee Textile Mills v. Com'r, 5 T. C. 175 (1945); Vica Company v. Com'r, 5 T. C. (No. 61, 1945).

[59] Blum Folding Paper Box Co. v. Com'r. 4 T. C. 795 (1945).

[60] Idem.

[61] I. R. C. Sec. 3770 (a) (2) and 3775 (a).

[62] 302 U. S. 56 (1937).

the general rule indicated above will now be considered.

Overpayment and Deficiency for the Same Taxable Year—In the leading case of *Lewis, et al., Trustees v. Reynolds,*[63] the Supreme Court held that an overpayment may be reduced and offset by a barred deficiency asserted with respect to the *same* taxable year as to which the taxpayer claims the overpayment. The theory of the decision is that before a taxpayer is entitled to a refund, he must establish that he has, in fact, overpaid his taxes for the taxable year in question, and there can be no overpayment unless the amount paid by the taxpayer actually exceeds the amount which might have been properly assessed and demanded.[64]

However, the rule of the *Lewis* case, *supra*, does not apply where the overpayment and the outlawed deficiency relate to *different* taxable years. Thus, in *American Light & Traction Co. v. Harrison,*[65] the taxpayer failed to report a gain on an exchange of stock of one corporation for bonds of another in 1928, because the Commissioner had erroneously held that the exchange was tax-free. Upon sale of the bonds in 1933, the taxpayer reported a gain. However, it sued for a refund, claiming that it was entitled to a higher basis for the bonds sold because they were acquired in a taxable exchange in 1928. The taxpayer's claim was allowed in full, even though the amount of the tax which should have been paid in 1928 was admittedly in excess of the overpayment claimed for 1933. Since two entirely different taxable years were involved, it was held that the deficiency for the earlier year barred by the statute of limitations could not be offset against the overpayment made in the later year.

Overpayment and Deficiency Arising from the Same Transaction—The principle of equitable recoupment was extended by the Supreme Court to situations where the *same transaction* gave rise to both an overassessment and a deficiency. The leading case on the subject is *Bull, Ex'r. v. U. S.*[66] There, the taxpayer-executor was seeking to offset an overpayment of estate tax made in 1921, refund of which was barred by the statute of limitations, against an additional income tax determined by the Commissioner against the estate, which was paid in 1928. The estate tax overpayment and the income tax deficiency resulted from different phases of the *same transaction*, namely, partnership profits earned subsequent to the decedent's death which were paid over to his executor. The Commissioner had erroneously included these partnerships profits as part of the decedent's gross estate, upon which the executor paid an estate tax in 1921, and the same partnership profits were the subject of the additional income tax assessed by the Commissioner against the estate in 1925 and paid in 1928. The Court held that the estate was entitled to recoup the estate tax overpayment by way of credit against the income tax deficiency, even though the statute of limitations had barred suit on the overpayment. The Court pointed out that under the circumstances of the case retention by the government of the estate tax overpayment "was against morality and conscience."

The principle of the *Bull* case, *supra*, has been limited in its application to the relief of the identical taxpayer. Thus, it has been held that an overpayment of estate tax of the deceased husband may not be offset against income tax imposed upon the

[63] 284 U. S. 281 (1932).
[64] Otis Elevator Co. v. U. S., 36 F. Supp. 328 (Ct. Cls., 1941).
[65] 142 F. (2d) 639 (C. C. A. 7, 1944).
[66] 295 U. S. 247 (1935).

wife;[67] nor may the taxpayer, as trustee of one trust, be credited with overpayments made as trustee of other separate and distinct trusts.[68]

The rule of the *Bull* case, *supra*, has been applied in favor of the government as well the taxpayer. Thus, the government was permitted to recoup a barred gift tax deficiency against an estate tax refund.[69]

In order to offset an overpayment and tax deficiency against each other, it is essential that they both arise out of substantially the same transaction, permitting a redetermination of the entire tax liability on the transaction as a whole. Otherwise, the rule applies that a stale tax deficiency may not be used to defeat a good and valid claim for refund and, vice versa, an outlawed claim for refund may not be used to diminsh a valid tax deficiency.[70]

Overpayment and Deficiency on the Part of Trustee and Beneficiary—Finally, a further extension of the doctrine of equitable recoupment was made by the Supreme Court in situations involving the close relationship of trustee and beneficiary. In *Stone et al, Trustees v. White*,[71] it was held that trustees who had paid a tax on income, which should have been paid by the beneficiary, were not entitled to recover the tax where the government's claim against the beneficiary was barred by the statute of limitations. Since recovery by the trustees would inure to the benefit of the beneficiary, the Court reasoned that it would be unfair to permit the trustees to recoup the tax for the account of the beneficiary, while the latter escaped payment of the tax altogether.

The rule of the *Stone* case, however, does not apply to every instance where several taxpayers stand in some degree of relationship to each other. Thus, recovery was allowed to the president of a corporation for income tax that he paid on a promissory note given to him by the corporation for salary, where the note was determined never to have been intended as payment but only as permanent evidence of the debt, even though the government could no longer recover any tax from the corporation by reason of its insolvency and the running of the statute of limitations.[72]

Recoupment Not Allowable in Tax Court Proceeding—The Supreme Court has ruled that the Tax Court does not possess general equity jurisdiction and is, therefore, impotent to entertain a plea of recoupment involving different taxable years.[73] The facts of the case establish that the equities were all with the taxpayer and clearly came under the doctrine of *Bull v. U. S., supra.* The Commissioner reduced the taxpayer's *opening inventory* for the fiscal year 1936 by $237,000, producing an additional tax of about $15,000. Identical adjustment of the *closing inventory* for the fiscal year 1935 shows that the taxpayer overpaid 1935 taxes by $8,000; however, refund for that year was barred by the statute of limitations. The taxpayer asked the Tax Court to offset the 1935 overpayment against the 1936 deficiency, since both were caused by the single act of adjusting the selfsame item of inventory. The Tax Court ruled that it had no statutory authority to allow the offset.

[67] Edmonds, Adm. v. Com'r, 90 F. (2d) 14 (C. C. A. 9, 1937).
[68] Huntington Nat. Bank, Trustee v. Com'r, 90 F. (2d) 876 (C. C. A. 6, 1937).
[69] Lit et al., Ex'rs v. U. S., 18 F. Supp. 435 (D. C. Penn. 1937).
[70] In re Clayton Magazines, Inc., 77 F. (2d) 852 (C. C. A. 2, 1935); Lyeth v. Hoey, 112 F. (2d) 4 (C. C. A. 2, 1940).
[71] 301 U. S. 532 (1937).
[72] Schlemmer v. U. S., 94 F. (2d) 77 (C. C. A. 2, 1938).
[73] Com'r v. Gooch Milling & Elevator Co., 320 U. S. 418 (1943), rev'g 133 F. (2d) 131 (C. C. A. 8, 1943), which reversed B. T. A. Memo Decision, Dec. 17, 1941.

since the only taxable year before it was the proposed deficiency for 1936. The Eighth Circuit Court, in a 2-to-1 decision, reversed the Tax Court, holding that the doctrine of equitable recoupment was properly applicable to a situation such as this. However, the Supreme Court ruled that the Tax Court was right and the Circuit Court wrong. Suppose, instead of seeking review by the Tax Court, the taxpayer had paid the 1936 tax deficiency and then sued for a refund in the District Court or the Court of Claims, could the federal courts, possessing general equity jurisdiction, grant relief to the taxpayer by way of equitable recoupment? The Supreme Court declared that it was not passing upon this question but it may be of significance that the Court referred to its decisions in *Bull v. U. S.* and *Stone v. White,* discussed *supra.* Because of this lack of general equity jurisdiction, the Tax Court refused to allow as recoupment against an income tax deficiency an erroneous gift tax payment in a prior year, for which a claim for refund was barred by the statute of limitations.[74] Cf. *Scarfe Co. v. Com'r.*[75]

Estoppel—Regardless of the doctrine of equitable recoupment, a taxpayer may not recover a refund where he is estopped by his own conduct. Thus, refund was denied to a taxpayer where the Commissioner, acting upon the taxpayer's request, credited an over-assessment against a deficiency for the preceding year, assessment of which was barred by the statute of limitations. The Supreme Court held that the statutory provision, voiding the credit of overpayments against outlawed deficiencies, was no bar unless the credit was "made by the Commissioner of his own motion without the taxpayer's approval or with approval falling short of inducement or request."[76] A similar conclusion was reached in another case where, pursuant to an agreement with the taxpayer, the Commissioner credited an overassessment due to the taxpayer individually against the tax liability of a partnership of which the taxpayer was a member.[77]

Conditions Precedent to Suit for Tax Refund

In general, there are five principal conditions affecting the taxpayer's right to maintain an action in court for the recovery of taxes erroneously paid or illegally collected. Briefly stated, they are:

(1) The tax must have been paid. This requirement is obvious, for there can be no overpayment if no tax was paid. However, full payment of the total tax liability shown on the taxpayer's return or of the entire amount assessed by the Commissioner is not a condition precedent to suit. The taxpayer may sue to recover the portion of the tax actually paid.[78] The suit may be maintained whether or not the tax has been paid under protest or duress.[79]

(2) A valid and timely claim for refund must have been filed.[80] This is an absolute and indispensable prerequisite to an action in court for refund of taxes.[81]

(3) The suit must be instituted within the prescribed statutory period. I.R.C. Section 3772(a) provides:

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[74] Robert G. Elbert v. Com'r, 2 T. C. 892 (1943).
[75] 47 B. T. A. 964 (1942).
[76] R. H. Stearns v. U. S., 291 U. S. 54 (1934).
[77] Daube v. U. S., 289 U. S. 367 (1933).
[78] Coates v. U. S., 111 F. (2d) 609 (C. C. A. 2, 1940); Sirian Lamp Co. v. Manning, 123 F. (2d) 776 (C. C. A. 3, 1941).
[79] I. R. C. Sec. 3772 (b).
[80] I. R. C. Sec. 3772 (a) (1).
[81] U. S. v. Felt & Tarrant Mfg. Co., 283 U. S. 269 (1931); Dixie Margarine Co. v. Shaeffer, 130 F. (2d) 221 (C. C. A. 6, 1943).

(a) Suit may not be commenced *before* the expiration of six months from the date of filing of a claim for refund unless the Commissioner renders a decision within that time.

(b) No suit may be commenced *after* the expiration of two years from the date of mailing by registered mail by the Commissioner to the taxpayer of a notice of the disallowance of the part of the claim to which such suit or proceeding relates.

(c) Reconsideration of the claim or any other action taken by the Commissioner after the mailing of the notice of disallowance does not extend the time for bringing suit.

The importance of strictly observing the two-year period of limitation for the commencement of suit cannot be stressed too strongly. In one case, the taxpayer filed suit "one day too late" because the preceding day fell on a Sunday, and his complaint was dismissed.[82]

(4) The suit must be maintained on the grounds stated in the claim for refund. Recovery will be denied if new or different grounds are urged at the trial. In one case, [83] which is illustrative, the taxpayer's claim for refund was based on the ground that it was entitled to an allowance for obsolescence. At the trial, it sought to recover on the theory that it sustained a loss resulting from abandonment of the property. The Supreme Court ruled that in the absence of a waiver by the government or a proper amendment of the claim, the "petitioner is precluded in this suit from resting its claim on another ground."

(5) Finally, the suit must rest on the facts and evidence presented to the Commissioner prior to the rejection of the claim for refund. In *Samara v. U.S.*,[84] the court precluded the taxpayer from offering evidence as to facts not set forth in his claim and dismissed his complaint, reasoning that he could not possibly succeed if his proof was limited to the facts stated in his claim.

Types of Action

In general, there are four kinds of action which may be brought for the recovery of taxes erroneously assessed and collected, viz:-

(1) An action in the District Court against the collector who wrongfully exacted the tax.

(2) An action against the United States prosecuted either in the District Court or the Court of Claims, under the specific authority and jurisdiction conferred on these courts by statute.

(3) An action against the United States upon an account stated, which may be brought only in the Court of Claims.

(4) A proceeding in the Tax Court for the determination of an overpayment, where such proceeding involves a contested tax deficiency proposed by the Commissioner for the same taxable year.

These remedies are not cumulative. A claimant must make an election as to whether he should sue the collector who received the tax or the United States as well as the court in which to bring the action. He cannot join both the collector and the United States as parties-defendant in the same action.[85] Nor may suits on the same claim be prosecuted simultaneously in the Court of Claims and in the District Court.[86]

[82] Ferd Mulhens, Inc. v. Higgins, 55 F. Supp. 42 (D. C., N. Y., 1943).
[83] Real Estate-Land Title & Trust Co. v. U. S., 309 U. S. 13 (1940).
[84] Cited as Note No. 54, supra; see also cases cited at Notes Nos. 57, 58 and 59, supra.
[85] T. D. 3910, V-2 C. B. 104 (1926); Ohio Locomotive Crane Co. v. Denman, 73 F. (2d) 408 (C. C. A. 6, 1934).
[86] Judicial Code, Sec. 154, 28 U. S. C. A. §260; New Jersey Worsted Mills v. U. S., 9 F. Supp. 605 (Ct. Cls., 1935).

An action against the Collector cannot be amended to substitute the United States as the defendant, afer the statute of limitations has barred an action against the United States, even where the claim is reduced to $10,000.00.[87]

A suit may not be brought against the collector in the District Court, after the Court of Claims has dismissed a suit against the United States on the same issue.[88] The decision in that case was based on the principle of *res adjudicata.* In a converse situation, however, the Supreme Court held that a judgment against the collector did not bar a subsequent action against the United States for an additional refund for the same taxable year.[89] To remedy this situation, Congress, in 1942, amended the Internal Revenue Code, making an adjudication against a collector or his personal representative *res adjudicata* with respect to all suits instituted after June 15, 1942 in the Federal Courts as well as the Tax Court.[90]

Factors Affecting Choice of Court

Under the statutory provisions applicable to refund suits, the taxpayer is given a certain amount of leeway in selecting the court in which to bring his action as well as the defendant against whom he wishes to proceed. The choice will depend upon an appraisal of the advantages and disadvantages of the factors outlined below in relation to the taxpayer's particular circumstances:

(1) *Quick Trial*—In view of the congested trial calendars in many District Courts, a case can usually be reached more quickly in the Court of Claims where, after joinder of issue, it is immediately referred to a commissioner to take testimony and make findings of facts.

(2) *Jury Trial*—The right to have a case trial by a jury can be availed of only in an action brought against the collector in the District Court. Where the United States is named as the defendant in a District Court action, the statute specifically provides that the case "shall be tried without a jury." In actions before the Court of Claims, there is no such thing as a trial by a jury; as a rule, the testimony is heard by a commissioner or taken on deposition.

(3) *Proximity of the Court*—The convenient location of the court is a factor that may influence the ultimate decision. A District Court action against the collector must be brought in the district where the collector resides at the time the action is commenced. On the other hand, if the United States is named as the defendant, the action must be brought in the district in which the plaintiff resides. In suits before the Court of Claims, the petition must be filed in Washington. Testimony taken before a commissioner of the Court of Claims can be taken at any place desired by the parties, while testimony in a District Court case is usually taken in court.

(4) *Hearing of Testimony* — In cases pending before the Court of Claims, the testimony is usually taken before a commissioner who makes his report to the court; the court itself does not see the witnesses or hear the evidence. On the other hand, in a District Court action, all the testimony is heard by the judge and jury (if there is a jury) and the court is, therefore, in a position to weigh the credibility of the witnesses and evaluate the evidence first-hand.

(5) *Decision Trends*—In some instances, the choice of the tribunal may be influenced by the trend of decisions in the various courts. For example, in the family partnership cases, some of the District Court decisions indi-

[87] Hammond-Knowlton v. U. S., 121 F. (2d) 192 (C. C. A. 2, 1941).
[88] Second National Bank of Saginaw v. Woodworth, 66 F. (2d) 170 (C. C. A. 6, 1933).
[89] U. S. v. Nunnally Investment Co., 316 U. S. 258 (1942)
[90] I. R. C. Sec. 3772 (d) added by Rev. Act of 1942, Sec. 503.

cated a more liberal trend than those of the Tax Court. If a taxpayer wishes to offset an outlawed overpayment for one year against a tax deficiency for another year, both arising from different phases of the same transaction, it will be advisable for him to sue in the District Court or the Court of Claim, rather than in the Tax Court which lacks the equity jurisdiction to entertain the plea of equitable recoupment.[91]

(6) *Refund Proceedings in the Tax Court*—The Tax Court is the only court in which a taxpayer confronted with a proposed deficiency may contest the deficiency and ask the court to find an overpayment in his favor. In tax refund suits brought in the other Federal courts, the rule is that the taxpayer must first pay the contested tax and sue for a refund later. However, the jurisdiction of the Tax Court is strictly limited to cases involving a proposed deficiency and its determination of an overpayment is confined to the taxable year or years covered by the statutory notice of deficiency.

(7) *Appellate Review*—The availability of an appeal from an adverse decision of the Trial Court is an important factor to be taken into consideration. Under the present law, a decision of the Court of Claims is final and conclusive, except that the aggrieved party has the right of petitioning the Supreme Court for review on certiorari. However, applications for review to the Supreme Court are sparingly granted unless the case involves important questions of law or there is a conflict in the decisions of the lower courts. On the other hand, a decision of a District Court or of the Tax Court may be reviewed as a matter of right by the Circuit Court of Appeals and the latter's decision may, in turn, be reviewed by the Supreme Court on a writ of certiorari in the same manner as a decision of the Court of Claims. However, the scope of review by the Circuit Courts of Appeals has been drastically circumscribed by the decision of the Supreme Court in the *Dobson* case.[92]

In addition to the foregoing factors, there are those imponderables of personal predilection, such as the natural preference of an attorney for the court in which he appears more frequently and with whose rules of practice, procedure and evidence he is more familiar.

Jurisdiction of The Various Federal Courts

A claimant may institute suit for the recovery of taxes illegally or erroneously paid in the District Court, in the Court of Claims or in the Tax Court of the United States, provided certain statutory conditions precedent for the filing of suit have been fulfilled. In certain instances, the claimant is confined to one forum; at other times, he is given a choice of several courts in which to bring his suit for refund. The following outline shows the jurisdiction of the different Federal courts over refund suits, when such jurisdiction is exclusive or concurrent, whether the suit must be brought against the collector or the United States, and the amount of the claim over which the court has jurisdiction under the various conditions indicated:

I. EXCLUSIVE JURISDICTION
  (A) DISTRICT COURT only:[93]
    (1) *Defendant* — Collector to whom tax was paid, whether he is still in office, or has resigned, or if he be dead, his personal representative.
    (2) *Amount*—No limitation as to amount of claim.

[91] See page, supra.
[92] Dobson v. Com'r., 320 U. S. 489 (1943)
[93] 28 U. S. C. A. § 41 (5)

(B) COURT OF CLAIMS only:[94]

(1) *Defendant* — United States.

(2) *Amount*—No limitation as to amount of claim.

(C) TAX COURT only:[95]

(1) *Defendant* — Commissioner of Internal Revenue.

(2) *Conditions* — Only if the preceding is properly before the Tax Court on a petition to redetermine a deficiency and the petitioner claims an overpayment of tax for the taxable year involved.

(3) *Amount*—Overpayment may be determined only for the taxable years with respect to which a deficiency is contested.

II. CONCURRENT JURISDICTION[96]

(1) *Defendant*—United States.

(2) *Conditions*:

Either DISTRICT COURT or COURT OF CLAIMS

(a) If the claim is less than $10,000 (regardless of whether or not the collector is living or in office);

OR

(b) If the claim exceeds $10,000, then only if the collector is dead or not in office at the time suit is commenced.

Suits Against the Collector

A suit for refund of internal revenue taxes, regardless of the amount of the claim, may be brought in the District Court against the collector who collected the tax, whether he is still in office or has resigned, and if he has died, the suit may be maintained against his personal representative.[97]

The right to sue a collector for an unjusified collection was given at common law[98] and is expressly recognized by statute.[99] A suit against the collector is personal in nature. It is founded upon the common law action of *indebitatus assumpsit* and is analagous to an action for money had and received.[100]

Being personal in nature, the suit must be maintained against the collector who actually received the tax, or if he died, against his personal representative. Thus, an action will not lie against his successor in office.[101] If taxes for different years were paid to different collectors, the taxpayer cannot recover the entire amount of such taxes from any one of the collectors.[102] If taxes for any given year were paid to two different collectors, a separate refund suit may be maintained against each collector.[103]

A collector who credits an overpayment against an outlawed tax liability for a prior year in effect collects the tax and can be sued for a refund.[104]

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[94] 28 U. S. C. A. § 250

[95] 95 I. R. C. Sec. § 322 (d), 912 and 1027 (d)

[96] 28 U. S. C. A. § 41 (20)

[97] 28 U. S. C. A. § 41 (5)

[98] U. S. v. Emery, Bird, Thayer Realty Co., 237 U. S. 28 (1915)

[99] 28 U. S. C. A. § 41 (5)

[100] U. S. v. Nunnally Investment Co., 316 U. S. 258 (1942); Sage et al. v. U. S., 250 U. S. 33 (1919); Gans Steamship Line v. Bowers, 82 F. (2d) 181 (C. C. A. 2, 1936)

[101] Smietanka v. Indiana Steel Co., 257 U. S. 1 (1921); Union Trust Co. et al. v. Wardell, 258 U. S. 537 (1922)

[102] Coffey et al. v. Exchange Bank of Lenox, 296 Fed. 811 (C. C. A. 8, 1924)

[103] U. S. v. Kales, 314 U. S. 186 (1941)

[104] Graham et al. v. Goodcell, 282 U. S. 409 (1931)

However, where a collector credited an overpayment against a barred deficiency pursuant to the Commissioner's instructions and the credit had not been finally approved and certified to by the Commissioner, suit against the collector was dismissed as the bookkeeping entry made by the collector was not considered the equivalent of collection of the tax.[105]

A District Court action against the collector must be brought in the district where the collector resides at the times of the commencement of the action.[106] This rule applies whether the collector is still in office or not and regardless of the fact that the tax may have been paid in some other district.

Despite the technical distinctions between a suit against the collector and a suit against the United States, the real party in interest is the government. The collector's defense is conducted by a United States attorney.[107] Upon certification by the court that there was probable cause for the act done by the collector or that he acted under directions of the Secretary of the Treasury or other proper officers of the government, no execution may be issued against the collector.[108] In the end, the judgment recovered by the taxpayer is paid by an appropriation from the Treasury.[109]

Although the statutes have for most practical purposes reduced the personal liability of the collector to a fiction, at least one point of distinction still remains intact—the right to a jury trial, which is available only in a suit against the collector, but not against the United States.[110]

Suits Against the United States

The United States as a sovereign cannot be sued unless it consents thereto.[111] As previously shown, Congress, by various statutory enactments, has specifically granted this right to sue the government for refund of taxes erroneously paid or illegally collected. However, no suit may be maintained against the government unless there is meticulous compliance with the terms of the statute and, in the absence of waiver, with the conditions imposed by the Treasury Department under the rule-making power delegated to it by Congress.[112]

In the Court of Claims, there is no limitation upon the amount of the claim for which the United States may be sued.[113] In the District Court, however, no action may be maintained against the United States upon a claim in excess of $10,000, if the Collector who received the tax is alive or in office; otherwise, there is no limitation on the amount.[114]

As a defendant in a refund suit, the United States is bound by the same rules of practice and procedure as any private litigant and does not enjoy any special privileges by reason of its sovereign character.[115]

In a refund suit against the United States, the collector who received the

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105 Gans Steamship Line v. Bowers, cited at Note No. 100, *supra*.
106 28 U. S. C. A. § 112.
107 28 U. S. C. A. § 485.
108 228 U. S. C. A. § 842.
109 Idem
110 United States v. Kales, cited at Note No. 103, *supra*.
111 U. S. v. Sherwood, 312 U. S. 584 (1941); Hastings v. Herold, 184 Fed. 759; Brainard v. Hubbard, 79 U. S. 1.
112 Angelus Milling Co. v. Com'r, 65 S. Ct. 1162 (1945) and cases there cited.
113 28 U. S. C. A. § 250.
114 28 U. S. C. A. § 41 (20)
115 In re Minot Auto Co., Inc., United States v. Hines, 298 Fed. 583 (C. C. A. 8, 1924); In re Anderson, 279 Fed. 525 (C. C. A. 2, 1922); U. S. v. Bernstein, 16 F. (2d) 233 (C. C. A. 8, 1926).

tax may not be joined as a defendant.[116] An action upon an account stated resulting from a certificate of overassessment can only be brought against the United States.[117]

If a refund suit is instituted against the United States in the District Court, the action must be brought in the district where the taxpayer resides at the time of commencement of such action.[118] A refund suit in the Court of Claims is initiated by the filing of a petition with the clerk of the Court in Washington.[119]

A suit against the United States deprives the taxpayer of the right to a trial by jury.[120]

An alien cannot maintain a suit for refund in the Court of Claims unless he establishes that a reciprocal right of action is accorded to American citizens by his government.[121] This limitation, however, does not apply with reference to suits against the collector.

Suit Upon an Account Stated

To escape the bar of the two-year statute of limitations applicable to the ordinary tax refund suit, taxpayers have, in many instances, sought to recover overpayments of taxes by bringing suit upon an account stated. In the ordinary tax refund suit, the taxpayer's cause of action is predicated on the theory that the taxes in dispute were erroneously and illegally assessed and collected. In an action upon an account stated, recovery is sought upon the Government's promise to pay implied in a certificate of overassessment made and delivered by the Commissioner to the taxpayer.[122] Generally, an "account stated" is said to exist where a fixed sum is admitted by one party to be due to the other, and there is a promise, express or implied, for the payment of such amount, and the other party assents to the statement of the account.[123]

The chief advantage of an action based on an account stated is that the suit may be brought within six years after the cause of action has accrued,[124] which is the date of delivery of the certificate of overassessment.[125] A claim for refund is not required in an action on an account stated, since it is not a suit for a tax refund.[126]

Since this type of action is necessarily against the United States, suit may be brought either in the Court of Claims or the District Court if the amount involved is $10,000 or less, and must be brought in the Court of Claims if in excess of that amount.

The principal obstacle to recovery in this type of action has been the taxpayer's inability to establish that the statement of account rendered was unconditional, definitive and final, thus giving rise to an absolute promise of payment by the government of the balance shown by the account. Generally, the certificate of overassessment prepared by the Commissioner has been held to evidence the promise of pay-

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[116] Stark et al. v. U. S., 14 F. (2d) 616 (D. C., Ohio, 1926, rev'd on another point 32 F. (2d) 453 (C. C. A. 6, 1929; Ohio Locomotive Crane Co. v. Denman, 73 F. (2d) 1408 (C. C. A. 6, 1934).

[117] Moses et al. v. U. S., 61 F. (2d) 791 (C. C. A. 2, 1932).

[118] 28 U. S. C. A. § 762.

[119] 28 U. S. C. A. § 265.

[120] 28 U. S. C. A. § 41 (20).

[121] 28 U. S. C. A. § 261; Aktiebolaget Imo-Industri v. U. S.,—F. Supp.—(Ct. Cls., 1944).

[122] U. S. v. A. S. Kreider Co., 313 U. S. 443 (1941); Wm. J. Friday & Co. v. U. S., 61 F. (2d) 370 (1932)

[123] Shipley Construction & Supply Co., v. U. S., 7 F. Supp. 492 (Ct. Cls., 1934)

[124] Judicial Code § 156

[125] Bonwit Teller & Co. v. U. S., 283 U. S. 258 (1931); Daube v. U. S. 289 U. S. 367 (1933); Wm. J. Friday & Co. v. U. S., cited at Note No. 122 supra.

[126] Wm. J. Friday & Co. v. U. S., cited at Note No. 122 supra.

ment requisite for recovery.[127] However, an exchange of correspondence between the Commissioner and the taxpayer may be sufficient to spell out the account stated and the implied promise to the pay the balance shown by such account.[128] The Commissioner's determination of an overassessment, the preparation of a certificate of overassessment to that effect and the sending of a telegram to the taxpayer directing her to file a claim for refund were held not to constitute an "account stated" but merely advice for the protection of her rights in case it should eventually be found she was entitled to the refund.[129] Similarly, a letter from the Commissioner to the taxpayer in which he admitted an overassessment of tax, followed by another letter to the effect that the matter was still under consideration, was held not to create an account stated.[130]

If the statement of account is provisional, tentative and lacking in finality, it will not serve as a basis for an action on an account stated. Thus, recovery was denied where the certificate of overassessment had not been delivered to the taxpayer, even though the Commissioner had signed the schedule of refunds and overassessments and had forewarded it to the collector together with the check for the amount of the overassessment in favor of the taxpayer.[131] Where the amount shown in a certificate of overassessment was credited against unpaid taxes for other years, it was held that there was no implied promise to refund the entire amount of the overassessment but only the balance due after offsetting the prior years' deficiencies.[132] In suing upon an account stated based on a certificate of overassessment, a taxpayer may not select the credit items in his favor and ignore the debit items which are against him.[133]

Where the taxpayer cannot sustain his cause of action on the theory of an account stated, he is bound by the two-year period of limitation applicable to tax refund suits and by the other conditions precedent applicable to such suits, such as the filing of a timely and valid claim for refund.[134]

[127] Bonwit Teller & Co. v. U. S., cited at Note No. 125 supra.
[128] Shipley Construction & Supply Co. v. U. S., cited at Note No. 123 supra; Midpoint Realty Co. v. U. S., 42 F. Supp. 76 (Ct. Cls., 1941).
[129] Marshall v. U. S., 26 F. Supp. 474 (1939)
[130] Schubring v. U. S., 46 F. Supp. 1006 (Ct. Cls. 1942)
[131] Daube v. U. S. cited at Note No. 125 *supra.*
[132] R. H. Stearns Co. v. U. S., 291 U. S. 54 (1934)
[133] Brooks-Scanlon Corporation v. U. S., 31 F. Supp. 151 (Ct. Cls., 1940)
[134] U. S. v. A. S. Kreider Co., cited at Note No. 122 supra.

Il Pensoroso (with apologies to John Milton)

By Thomas W. Byrnes, C.P.A.

DURING the recent political campaign, a metropolitan newspaper printed a biographical series of the candidates running for the top local offices. The article lauding an aspirant for reelection to the Comptrollership of the city contained the following statement: "HE IS JUST THE OPPOSITE OF THE DRIED STICK OF AN ACCOUNTANT ONE MIGHT IMAGINE. . . ." That is one journalist's idea of what accountants are, and sad to relate he is not alone in that opinion.

Why is it that many public accountants, and particularly principals, go about solemn-visaged and seemingly bearing the weight of the world on their shoulders? One might say that the accountant's responsibilities do not make for light-heartedness and a carefree attitude. Granted that theirs is a serious calling which requires deep preparation for, and constant alertness in the careful performance of, engagements. But other professionals also are obliged to keep abreast of changes in laws and operating techniques, and yet they are able to give sincere service without sacrificing a pleasing mien. A physician whose bedside manner is dolorous and whose daily au revoir to a very ill patient is "We are hoping for the best" would be a poor morale builder and would not gain in popularity. A lawyer who, by always referring to the uncertainty of jury reactions, would constantly advise settlement rather than litigation of good causes, would rarely achieve eminence in his profession. Optimism and cheerfulness are assets in all walks of life. The reason public accountants have risen in public esteem despite their glum behavior, is because of the valuable services they have rendered in a period of rapid and complicated changes.

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A defense may possibly be asserted for the demeanor of the harassed public accountants of the fairly recent past, but it will not hold true for the practitioners of the future. In a great many cases the selection of a vocation by the elders was accidental. A new field of endeavor was opened in the early years of the 20th century and ambitious young persons, finding the other professions crowded, flocked to public accounting regardless of personal aptitude. At that time little or no technical preparation was available and in fact very slight attention was given to previous education. Which meant the sternest kind of application by the sincere to the work in hand, supplemented by study far into every night and weekend of whatever material could be found pertaining to commerce, accounts, finance, and commercial law. There was no time left for social intercourse, or cultural or recreational diversions. This narrow restriction to business facts and figures undoubtedly left its dour mark on the dispositions of the accountants of the early 1900's who probably are those whom the journalist quoted above had in mind.

However, no such case can be presented for persons now contemplating entrance into the profession. They possess decided advantages over the

pioneers and the latter's immediate followers. Aptitude tests are available and for the successful hurdlers of these, standardized pre-professional requirements have been established in the various States. The tendency here is toward the completion of a four year college education and it is in these undergraduate years that students should among other things, learn to mingle pleasantly with others and to cultivate cheerful dispositions. During this period also, programs of studies may be arranged to permit the development and enjoyment of cultural leanings and outdoor activities, all of which tend toward happier human contacts. Thus, the way of future practitioners has been eased to the extent that they will be partly trained for their chosen career *before* accepting employment, hence can plan to devote some of their future leisure hours to the arts and the social pastimes which will make for more congenial accountants.

The acquaintance with the more meaningful things of life and the broadening influence of participation in the other campus activities will, in this scribe's humble opinion, do much to brighten the future public accountant's general approach to things mundane, and, by enabling him to say with Milton "Hence, loathed Melancholy," make him a much more acceptable member of the human family.